IQ
INSIDER QUARTERLY

AUTUMN 2018 ISSUE 67

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ON THE COUCH

Is the reinsurance industry suffering an existential crisis? *IQ* takes notes...

The intelligent quarterly from the publishers of *The Insurance Insider*

INSURANCE VARIATIONS

French composer Erik Satie once likened his magnificent Gymnopédies piano variations to the experience of an observer walking slowly around a statue, describing what they see.

The mental picture you are painting is the same, but as your viewpoint changes, so does your perspective – some things come into view while other elements recede and then disappear. Thus the image changes subtly as you circle.

Satie understood that lot depends on your point of view. Were he around today I would have offered him a commission for this autumn's *IQ* like a shot.

Reading our quartet of brilliant main features one after the other may provoke this reaction: What a great industry we live in. What a world. What a place to develop a career. What abundant opportunities that stretch out a lifetime!

Or this: What a failing industry. What a world. What a place to try to carve out a career. Dwindling opportunities that will diminish day by day!

As I said, it does depend on where you are looking from.

One thing's for sure. There has never been a better time to be an insurance journalist – the sculpture that we are circling is evolving at such a rate that by the time we have completed a full circuit, it has changed.

It's as if the sculptor was a restless soul, who, as soon as we are out of sight, takes up her hammer and starts chiselling furiously away at her work. She is never satisfied. Even if the piece is in a museum she is dying to sneak in and start re-defining her oeuvre.

So what you have before you are sketches of different limbs and vital organs, facial features and distinguishing marks.

These four speeding horsemen of the apocalypse – (or four pillars of the establishment – you will have to make up your own mind) provide you with a snapshot of how our sector is evolving today and what opportunities and threats it is facing:

The existential debate over reinsurance, the InsurTech phenomenon, an in-depth interview and dissection of MGAs with one of the industry's greatest entrepreneurs and a deep dive into a reloaded and resurgent ILS world post-HIM.

Any one of these could have graced the front cover of the magazine. It is quite a gallery show.

We have had an abundant creative harvest after a long, hot summer of pacing round and around with our sketch books.

But all four are variations on the same thing.

Just like a Satie composition, everything is connected to the same body, but that body is different every time you look.

It all boils down to where and how value is best being added in our industry.

Our sector is all about sourcing, distributing, understanding, pricing and covering risk. To do this, you need marketing reach, risk selection skill and risk insight that helps the customer. And of course you need capital; either that, or highly reliable access to capital.

You need to be competitive and efficient and you need to know how to optimise your returns without surprising or indeed burning your capital partnerships. You cannot stand still for a minute.

You must keep walking around the body and spotting where you can make useful adjustments that smooth or improve the whole.

Welcome to the insurance sector in 2018 – it's scary and exciting in equal measure.

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AROUND THE WORLD

IQ's roundup of regional market developments

JAPAN

Japan flood losses as high as $4bn

Catastrophe modelling firm AIR Worldwide has estimated that industry-wide insured losses from the flooding in western Japan in July are likely to reach 284bn yen to 423bn yen ($2.6bn-$4bn).

An earlier Aon report, seen by sister publication *The Insurance Insider*, estimated that losses would be less than $1bn, based on damage to 347 dwellings and flooding of 9,868 more.

However, the AIR report cited data issued by Japan's Fire and Disaster Management Agency on 8 August which said more than 46,000 residential buildings had been destroyed, damaged or inundated by the floods.

Several days of record-breaking rainfall, from 28 June until 8 July, led to widespread inland flooding in more than 30 prefectures across western and south-central Japan and the loss of at least 200 lives.

AIR noted that in addition to major damage to buildings and infrastructure, the floods caused considerable business interruption, particularly to auto and electronics manufacturers.

US

California fires under control

Firefighters have gained the upper hand against the three largest Californian wildfires, but official updates have revealed further property damage.

The Carr Fire, which had been burning for almost a month, was 85 percent contained as of 19 August, according to an update from the California Department of Forestry and Fire Protection (CalFire).

The fire has now affected 227,098 acres and destroyed 1,604 buildings, of which around three-quarters were residential. A further 279 buildings have been damaged, CalFire said.

Further south, the Mendocino Fire has been largely controlled. The fire comprised two large blazes. The smaller of the two, the River Fire, is now 100 percent contained, according to a 19 August CalFire update. The Ranch Fire, which at 341,047 acres covered an area greater than Los Angeles, is now 76 percent contained.

In total, the Mendocino Fire has destroyed 277 buildings and damaged 37 structures, with a further 1,050 at risk.

AUSTRALIA

Tasmania flood loss hits $73mn

Claims stemming from severe flooding in Hobart and Kingston in the Australian state of Tasmania have neared A$100mn ($73mn), according to the Insurance Council of Australia (ICA).

The ICA said insured losses from the 11 May storm and the resulting floods have reached A$99.7mn from almost 8,800 household and commercial claims.

However, almost 90 percent of motor vehicle claims have been closed, as well as about 55 percent of home building claims and almost 45 percent of contents claims, the ICA said.

The Hobart catastrophe is the costliest natural disaster in Australia in the year to date. Bushfires in New South Wales and Victoria in March caused A$82.5mn in losses. Claims from Tropical Cyclone Marcus, which hit the Northern Territory on 17 March, resulted in A$62mn in insured losses. And flooding in north and central Queensland in early March delivered insured losses of A$17mn.

INDIA

Flood-hit Kerala faces $2.8bn bill

Economic losses from floods in the Indian state of Kerala could be as much as $2.8bn, according to the state's chief minister.

A particularly intense period of monsoon rainfall from 8-16 August caused several dams to near their maximum capacity.

The release of water from as many as 22 reservoirs exacerbated flooding downstream and resulted in the worst floods in Kerala since 1924, according to a report from Aon's Impact Forecasting, with at least 115 people reported killed.

The broker's modelling arm did not give an overall insured loss estimate at this stage. However, India's *Economic Times* cited a figure of 500 rupees crore ($71mn) across general and life insurance.

Impact Forecasting said losses related to tea, coffee, rubber and cardamom production in Kerala are estimated at $86mn.

Meanwhile, a blog post by JLT Re said the cost borne by tea alone would be $29mn, while the state's 'rubber belt' faced a $5mn loss.

Lumen Re

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Global market updates by class of business

Marine

Brit Global Specialty USA (BGSU) has affirmed its commitment to its US yacht business, after suggestions that its Lloyd's syndicate has pulled out of yacht cover.

Brit Americas president Nick Davies said the US team "targeted much smaller average hull values" and was based on a "very different strategy" to London.

"Yacht and our broader US-based marine offering remain an integral part of BGSU's platform as we continue to pursue profitable growth," said Davies.

Brit CEO Matthew Wilson added that the "highly-respected" US team offered "yacht, cargo and hull to US-based producers for business not traditionally accessed by the Lloyd's market".

Aviation

The reintroduction of US sanctions on Iran could hit international airlines flying into the country's capital, aviation underwriters have warned.

Measures introduced on 7 August target vehicle parts, commercial passenger aircraft and "related parts and services", leaving carriers uncertain if insuring airlines constitutes doing business with Iran.

Market sources said it was unclear whether carriers could continue to provide large airlines with aviation all-risk cover for international flights into Tehran Imam Khomeini International Airport.

Market sources canvassed said the market had to obtain greater clarity from the US Office of Foreign Asset Control over operations or international airlines would be unable to fly into Iran.

Cyber

The cyber market remains divided over the longevity of products designed to address coverage gaps between cyber and typical specialty policies, in the wake of a number of high-profile cyber attacks against large shipping corporations.

These gap products, which are targeted at industries such as aviation, marine and energy, can carry cyber exclusions, often termed CL380.

While brokers believe there is client demand for these gap coverages, some cyber underwriters have described them as "unsustainable", arguing that a more sustainable approach would be for property damage arising from cyber attacks to be written into standard marine, aviation or energy cover.

Cargo

Underwriters in the London cargo market are preparing to pay out about $45mn after a fire at a pharmaceutical laboratory in the Chilean capital Santiago.

Chilean pharmaceutical group Pharma Investi is understood to have submitted a claim after the blaze in the laboratory in the early hours of 22 April.

The Pharma Investi policy was placed by Gallagher and is led by Navigators, sources said. Pharma Investi specialises in treatments for chronic diseases and other high-tech therapies.

Shortly after the blaze, Chilean news website La Tercera said more than 10 divisions of the Santiago fire and police departments were called to fight the fire, which destroyed the laboratory. Gallagher and Navigators declined to comment.

Construction

The construction market is facing an approximate £100mn ($129mn) loss from the Glasgow School of Art fire.

Travelers Syndicate 5000 is the lead insurer on the construction all risks policy, with a 35 percent line on the Marsh-placed quota share. Talbot and StarStone are among the other carriers on risk.

The Glasgow School of Art's Mackintosh Building was severely damaged in a blaze that started on the night of 15 June.

Kier, the project's main contractor, took out the insurance policy when it began rebuilding the university building after a previous fire in 2014.

Workers' comp

The US workers' compensation market is set to generate underwriting profits in 2018 and a breakeven combined ratio in 2019, according to Fitch Ratings.

With direct written premium volume of $56bn in 2017, workers' comp has enjoyed three straight years of annual combined ratios of below 100 percent, the rating agency said. The last time the segment's combined ratio was over 100 percent was in 2014, when it was 101.8 percent.

Fitch said it expects pricing pressure in the class of business to continue, though it added that near-term premium volume "will likely benefit from exposure growth".

The rating agency cited the CIAB quarterly Commercial Property/Casualty Market Index Survey and other sources, adding that the segment's favourable performance is promoting greater market competitiveness and "steadily declining" premium rates.

Market intelligence on the QT

Bad publicity?

Former UK Foreign Secretary Boris Johnson has been attracting criticism again – not for inflammatory remarks about Muslim dress this time, but for the possibly deleterious effect his shenanigans may have had on a well-known insurance market outsourcing brand.

When his Oxfordshire home was besieged by journalists seeking comment on Boris' infamous *Daily Telegraph* article about the burqa, the tousle-headed troublemaker decided to see them off with a trayful of mugs of tea.

Unfortunately for technology service provider Xchanging, this was carried out while Boris was sporting not only a rather unsightly pair of swimming shorts but also a rather faded blue rowing fleece emblazoned with the firm's logo.

Given that Xchanging ended its sponsorship of the Oxford and Cambridge boat race in 2012 (which is presumably where the garment originated), it was likely to have been less than overjoyed to be reminded of its backing for the event in such a context.

It remains to be seen if Boris will row back on his gaffe.

Pepé Le Pew strikes back

An Oregon woman is reportedly suing the insurance company that underwrote her homeowners' policy, after alleging that the carrier short-changed her on a claim related to skunk damage.

According to an Associated Press report, Katherine Schaeffer filed the claim after a skunk sprayed her dog and belongings inside her home, ruining $112,000 worth of her possessions.

In a lawsuit filed against the insurer, Safeco Insurance, Schaeffer alleges that the firm only paid $2,000 for the damages.

In addition to the full claim amount, she is seeking a further $38,000 for other costs incurred following the incident, including cleaning and living expenses.

The claimant's lawyer told reporters that claims adjusters had failed to grasp the extent of the stench created by the skunk, arguing that a "special personal property rider" on the homeowner policy should have covered the damages to Schaeffer's possessions.

ON THE COUCH

After a $140bn cat year that led to no meaningful uptick in rates, reinsurers are facing a little soul searching. **Catrin Shi** takes reinsurance back to where it all began…

What do you do when everything you thought was logical and true just isn't the case anymore? What do you do if the history books can't guide you to the best path to take?

And what do you do when you've just taken $140bn of cat losses in one year and the prospect of making back that money is dim at best?

The cat events of 2017 have forced reinsurers to take a long hard look at themselves. The losses shone a harsh spotlight on the underlying profitability of reinsurance business, while the quick reload of third-party capital post-loss served as a wake-up call to the market that this non-traditional competitor is here to stay.

On the face of it, there seems to be little to be positive about for the traditional market.

You can picture a reinsurer, feeling a little bleak and weary, taking itself along to a therapist, lying on the couch with head in hands, and looking to thrash out the issues.

"What do I, as a reinsurer, do well?" it might ask. "Is what I do even of relevance or importance? Do my clients even need me anymore?"

The existential nature of these

> "You could make a strong argument that there is more value than ever in the reinsurance product"

questions suggests the discussion needs to be taken right back to basics.

Is reinsurance broken?

To start with, you might question whether reinsurance as a product is broken. Does it still have relevance for buyers, or have their needs changed beyond what the product was designed for?

Reinsurance provides buyers with efficient capital which can reduce volatility in their earnings and strengthen their capital position. And those are two desired outcomes which very rarely change for buyers, according to JLT Re's global head of analytics David Flandro.

"You could make a strong argument that there is more value than ever in the reinsurance product, as it's very economical in terms of its relative cost and, at the moment, less volatile than it used to be," he explains.

"So if you are a cedant and looking at reinsurance as a competitive form of financing in comparison to debt, or certainly equity, reinsurance is an increasingly attractive form of capital."

Indeed, despite wider industry consolidation, executives have said that demand for reinsurance is growing.

But almost every party in the (re)insurance industry is looking to expand their business, and reinsurance can help them achieve those growth targets, explains Matthew Moore, president and managing director of Liberty Specialty Markets (LSM), which houses Liberty Mutual's reinsurance division.

"Very crudely put, 10 years ago the question the reinsurer had to ask itself is how much risk can we assume at what price, to make the desired return," he says. "That is still true but the other question we have to ask ourselves is 'How can we help our customers grow?'"

Historically reinsurers have not been great at asking this question, Moore continues. However, by understanding the client better and offering a range of products which might benefit the client's needs, reinsurers can play a very valuable part in assisting with growth ambitions.

How did we get here?

So, the therapist might ask next, if the value in reinsurance as a product still holds, how did you, the reinsurer, find yourself in this position?

The (re)insurance industry has emerged from one of the heaviest cat years on record. It brought to an end a number of years in which there were benign cat loss levels, during which time property cat rates had sunk to levels which challenged technical pricing.

The expectation was that rates would jump following the cats, but they didn't. The JLT Re rate-on-line index showed risk-adjusted global catastrophe rates still lagged below 2016 levels after rising by 4.8 percent on average at 1 January, the first increase since 2012.

Even at 1 June – the property cat renewal date for loss-hit Floridian cedants – rates moved up by just 1.2 percent.

Overcapacity had smothered rate increases. Yes, the losses were bad, but they hadn't been extraordinary. The loss figures per event largely came within modelled expectations. There was no surprise, no shock, to scare off the ILS funds and cause carriers to withdraw capacity to such an extent that the supply-demand imbalance tipped in reinsurers' favour.

This situation may not have been so grave if the non-cat side of reinsurance hadn't also conceded to the soft market in the past 10 years.

Many in the market say that non-cat business – long-tail, non-event-driven lines – for the most part is grievously under-priced. For years it had been subsidised by cat business, and profitability of non-cat was allowed to slip. But the 2017 losses exposed it all.

> "Many in the market say that non-cat business – long-tail, non-event-driven lines – for the most part is grievously under-priced. For years it had been subsidised by cat business"

As one reinsurance executive tells *IQ*: "It's only when you hit a bump in the road that you realise how close your head is to the top of the car."

LSM's Moore explains: "Reinsurers have historically been over-reliant on cat business. We are now going into 2019 planning and people are going to their shareholders and having to face facts on the under-profitability of those lines."

He continues: "It's a reality in corporate life that when you're making money you can put off those very difficult decisions. I think the last 12 months have just shone a much harsher spotlight on that."

With that in mind, reinsurers now find themselves asking again whether the traditional market cycle is broken, particularly for property cat, which has traditionally been the lifeblood of the industry.

"I do believe in the market cycle. I have been hearing the cycle is dead in various forms throughout my entire career," says JLT Re's Flandro. "The cycle doesn't die, it just changes. Whereas before, cat losses really drove every line of business in the short term, things are now more nuanced and subtle."

Although prices have moderated over the last decade, cat rates remain generally higher than for most other risks although, for certain peak risk coverages, third-party capital has for now put a ceiling on pricing, Flandro explains.

"This changes the profit model of the sector. The best reinsurers will adjust, as they have done in the past."

Continued on page 12

Am I still relevant?

Perhaps the most challenging question for our imaginary reinsurer sat on the therapist's couch is how to ensure they are one of those top-quartile carriers.

In essence, how do you make yourself relevant in a market environment which has fundamentally changed?

All members of the (re)insurance value chain are trying to match capital to risk more quickly and at lower cost. The chain is complex and overstretched, and disintermediation to achieve both speed and cost savings is a real threat for all participating parties.

Everyone in the industry is looking at the components of the value chain and asking themselves, "Where is the residing sustainable value relating to the skills and attributes that we have?" according to Mark Hvidsten, deputy chairman of Willis Re.

"I think those towards the end of the chain are in the most vulnerable position in this evolving process," he says.

"The ultimate capital is interested in how it might be able to access the part of insurance risk it really likes, and whether the easiest way for them to do this is through the help of reinsurers, insurers, brokers, third-party asset managers or others."

As Willis Re president and global head of casualty Andrew Newman explains, (re)insurers have grown up in an era where capital and capital management determined who got the big spoils within the (re)insurance value chain.

> "(Re)insurers have grown up in an era where capital and capital management determined who got the big spoils within the (re)insurance value chain"

"The insurance industry model worked on the 19th century principle that capital was scarce and opportunity was plentiful," he says.

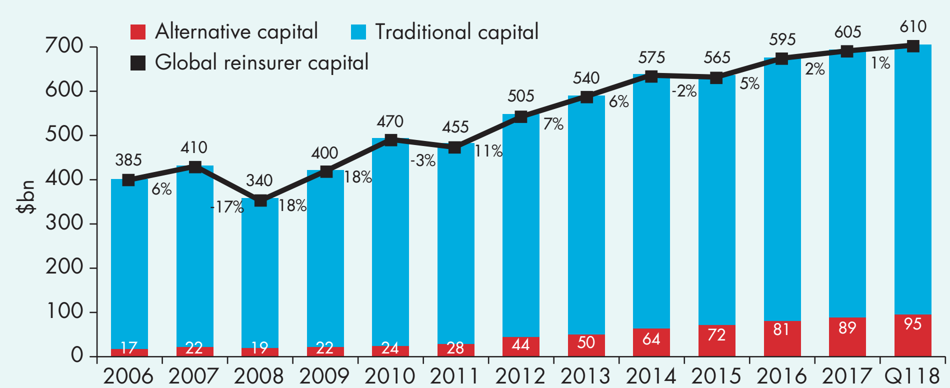
"Now in a world where there appears to be more capital on the planet than we know how to deploy – and let's assume that is a steady state for some time – originating portfolios of appropriately risk-priced business is the greater challenge."

A number of carriers in the industry believe the answer to this question is building scale, and with it capabilities, so they may access risk via a number of avenues. Reinsurance at these companies is merely a component, rather than the totality, of what they do.

AIG has pursued this course with its $5.6bn acquisition of Validus, as has Axa, which shelled out $15.3bn to buy XL Group.

Meanwhile, traditional reinsurers such as Swiss Re and Munich Re are also growing their insurance arms in earnest – allotting their capital to where they think the best opportunity lies in this new market.

Change in global reinsurer capital



Sources: Company financial statements, Aon Benfield Analytics, Aon Securities Inc.

Diversify or die?

LSM's Moore is a proponent of the diversified, multi-capability model, and is among the many in the industry who believe that in future, the reinsurance sector will be made up of fewer, larger companies each with multiple capabilities.

The executive believes that size and the ability to assume and price risk via a number of avenues not only offers economies of scale but also creates a huge advantage when it comes to working with the large brokers.

"You can have a much more productive conversation," he says.

The industry is also about to go through another phase where third-party capital will not only grow in volume but will also be applied much more intelligently, Moore claims. This capital will bring a multiplicity of return hurdles and different risk appetites.

Large and diversified carriers can act as a "shop front" for capital searching for risk, he explains.

"When you look at LSM Re alongside Liberty Mutual, we have a wide range of products at the moment but that will only continue to get wider," Moore says.

This view bodes ill for the pure-play reinsurer, of which admittedly very few remain. If being a jack-of-all-trades is the way to survive in this new market normal, what can a reinsurance purist bring to the table?

"There is clear difference between diversification in term of access to risk, and diversification in terms of risk itself," explains Emmanuel Clarke, president and CEO of pure-play reinsurer PartnerRe.

"We believe in diversification of risk itself – only 4 percent of our group net written premium is property cat, we are a leading reinsurer in many specialty lines and we have a growing life and health book."

Clarke notes that having a number of avenues to access risk doesn't always prove to be advantageous – those carriers which operated both insurance and reinsurance divisions actually took a double impact from the 2017 storms.

Unique abilities

PartnerRe inevitably has a unique position in the market as a private reinsurer with a long-term investor – and more importantly, an investor which is a proponent of the pure-play model.

Nevertheless, all investors still want to make a return, and how do you generate that return when reinsurance is fundamentally a lower-margin business than before?

"I don't necessarily think reinsurance is a low-margin business. I think everyone always thinks the grass is greener on the other side," says Clarke.

"Part of reinsurance has been increasingly commoditised and is now a lower margin business – there is no doubt about that, but for us this is a small part of the portfolio.

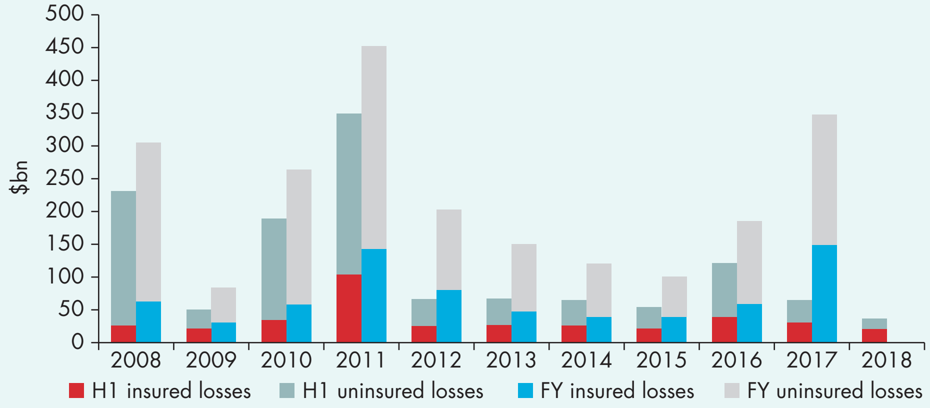
"We continue to shift the business towards a less commoditised, more customised, more expertise-intensive lines where the barriers to entry are higher and the returns are better. We have determined that success for us in terms of long-term value creation relies upon diversification across many classes."

The common theme between Moore's and Clarke's views is that risk selection and portfolio management are key – and this is a capability that transcends scale to a degree.

With the advent of big data, predictive modelling and machine learning, actuarial science could be set to change markedly in the years to come. Reinsurers need to stay at the bleeding edge of that, says JLT Re's Flandro.

"Portfolio management will be critical," he says. "Reinsurers will need to focus on their comparative, as opposed to competitive, advantage. What are they uniquely good at?"

Catastrophe-related losses



Sources: Swiss Re Institute

"Those who can both over-promise and over-deliver, avoid outsized losses and demonstrate leading performance have nothing to fear, because when you do that, capital will find you"

Portfolio management

Willis Re's Newman believes the people who will win are the people "who have always won" – those who can source, select, price and package risk, and thereby deliver stable, consistent risk-adjusted returns.

"However, what's changed is that originating a diversified book of business alone may not be enough; securitising it in whole or in part and introducing intelligent leverage into the balance sheet has become as important as capital management was in the (pre-securitisation) buy-and-hold era," he explains.

"Those who can both over-promise and over-deliver, avoid outsized losses and demonstrate leading performance have nothing to fear, because when you do that, capital will find you."

In fact, reinsurers could have an advantage here, says Willis Re's Hvidsten, because they are closer to the mindset that those who survive will need.

"Reinsurers are more agile in portfolio management, they have already started the thought process of finding cheap financing, and they are well down the road of defining what they are – which is effectively liability managers," he explains.

"They are actually closest to the core skill of portfolio management, which is going to be a big part of what it takes to carve out a sustainable position of value."

Reasons to be fearful

So as the therapist session comes to an end, and with all of the above in mind, do reinsurers have reason to be fearful? It's easy to take a pessimistic view of the market, particularly when you see how much risk is in the system and the mid-single digit returns reinsurers are getting for that risk, says Moore.

"There's a lot of old wise heads around saying you shouldn't write cat business at under 10 percent return on equity, and I don't dismiss that, but I think we are feeling pretty bullish [at LSM Re]," he says.

As a buyer of reinsurance in the wider Liberty group, "we know it's not a fantastic customer experience", the executive continues.

"I think if you as the reinsurer can be more customer-centric, you will be a lot more valuable to them," Moore says. "So with that in mind, there is a lot to be positive about."

CONNECTED RISK

As appetite for primary cyber business continues to grow, the standalone market for reinsuring these exposures appears to be lagging, writes **Laura Sanicola**

The cyber (re)insurance sector is undergoing rapid expansion, after the market bore the brunt of more than $400mn in aggregate losses across three major events last year.

According to a March PwC survey, around 75 percent of insurers are using reinsurance to manage the growth of their cyber exposures, and around 40 percent of respondents said they cede at least half of their cyber exposures to reinsurers.

Cyber incidents and claims ranked as US companies' biggest directors' and officers' coverage for the coming year, according to a July Willis Towers Watson survey. Some 80 percent of respondents identified cyber breaches as their top risk concern.

Policy limits are now five times larger than they were five years ago, according to a February PCS report, which found that currently some programmes have up to $500mn in limit.

Industry sources surveyed by this publication say that players such as TransRe, PartnerRe and Hannover Re have made a name for themselves as lead reinsurance carriers in the cyber space, with RennaisanceRe particularly known for its capacity to cover catastrophic events.

Aon Benfield and Guy Carpenter have emerged as leading cyber reinsurance brokers, while Chubb INA Group was the top cyber insurer in 2017, rising above AIG and XL Catlin America with $284.4mn in direct premiums written, according to analysis by AM Best earlier this year. AIG, which previously topped the table, dropped to second with $227.6mn in direct written premiums and had relatively flat year-on-year growth.

Cyber claims increased in 2017 to 9,017 from 5,955 the year before. Packaged policies were involved in 56 percent of the claims – increasing to 2.5 million in 2017 from 1.9 million in 2016, with a little over half of these policies featuring occurrence coverage triggers.

While 2017's highly public and large-scale cyber attacks underscored the growth of the market, they also left the industry grappling with how to prepare for resulting claims.

The Equifax breach in September 2017 and Merck's exposure to the NotPetya cyber attack in June last year caused economic losses of more than $1bn, according to industry experts.

The NotPetya attack affected private companies and state-run infrastructure around the world, with business interruption costs driving up economic and insured losses. The cost to global logistics firm Maersk alone was estimated at between $200mn and $300mn in lost revenue.

Frequency bump

However, these major events actually did not hit insurers or reinsurers that hard, according to Greg Dyer, senior vice president of North America casualty treaty at XL Catlin.

Individual carriers in the primary market had a little over $10mn in insurance cover in these instances, he says,

with privacy breaches among the largest drivers of insured losses.

While 2018 has not seen as many headline-grabbing data breaches as last year, the frequency of ransomware and smaller claims is up, says Dyer, though many of the claims were below insured retentions of coverage.

A majority of the carriers that were hit by cyber attacks did not purchase coverage. Furthermore, most ransomware attacks were below retentions for most reinsurers.

However, insurers and reinsurers have experienced a high demand for business interruption and other network security coverage in the past five years, according to Dyer.

"There's a fear that the software vulnerabilities that spread could hit multiple insurers on a book of business," Dyer says.

As it stands, loss ratios are below 55 percent across all markets, whereas the loss ratio for the US cyber industry stood at 32.4 percent across standalone and package policies in 2017 overall, according to a July Aon report based on US statutory filings.

> "The Equifax breach in September 2017 and Merck's exposure to the NotPetya cyber attack in June last year caused economic losses of more than $1bn, according to industry experts"

Typical limits

Writers of smaller risks for small and medium-sized enterprises typically provide around $1mn-$5mn in capacity in the London market, whereas those targeting medium-sized and large enterprises will offer limits of up to $15mn-$25mn. However, says Dyer, most insureds tend to purchase coverage in the $5mn-$10mn range.

The average cyber policy limit fell by 36 percent over the last six months to approximately $3.2mn, according to the Council of Insurance Agents & Brokers (CIAB), which biannually polls intermediaries from a range of brokerage firms and regional agencies whose clients range from small and medium-sized businesses to Fortune 100 companies across all industries.

Last autumn, the average policy limit was $5mn, the CIAB said. Historically, the average policy limit has been skewed by several larger policy limits ranging from $10mn to $50mn, but nearly 80 percent of respondents to the CIAB poll reported typical limits of less than $5mn.

The average largest limit placed by brokers in the past six months was approximately $75mn, according to the CIAB.

Typically, reinsurance purchases for cyber exposures are pro-rata and quota share, with an aggregate stop loss. These are often instituted as a way to control either adverse development on a book, or large systemic losses.

Some industry sources say that cyber rates are dropping marginally, but acknowledge that this may be due to the competitive marketplace.

Continued on page 16

"It's hard to evaluate rate change with expanding coverage," says Dyer.

Standalone shortage

While industry sources agree that the demand for standalone cyber coverage has grown, reinsurers might not have the appetite to write it, which means cedants may end up with cyber exposures included as part of a blended reinsurance cover.

Catherine Mulligan, head of US cyber at Aon Benfield and a managing director in Aon Re's global cyber practice group, estimates that about 70 markets currently write standalone cyber coverage.

Many carriers still reinsure their cyber exposures under professional liability or casualty treaties. Those with substantial books of business often want to buy cyber separately, while other carriers might not have sufficient volume to support a standalone cyber treaty, according to Mark Synott, global cyber practice leader at Willis Re.

Carriers which keep coverage under casualty or professional liability treaties get economies of scale, with any loss ratio caps that might be applicable to cyber elements getting the advantage of the overall loss ratio cap rather than the specific cyber elements. However, says Synott: "Their pre-existing treaties aren't designed for cyber."

Casualty underwriters often do not have the underwriting expertise in areas such as first-party covers or commercial crime issues which would be covered in a standalone cyber policy, says Mulligan.

Ceding companies are likely to get better terms and conditions if they're working with a willing cyber market, she says, adding that standalone products give both reinsurers and cedants more control over cyber exposures.

Synott says a third-party policy might not be designed to cover first-party exposures, causing a mismatch between the reinsurance cover provided and the reinsurance cover needed.

Furthermore, sources say, some cedants may feel that purchasing a standalone cyber policy might protect them from a change in the reinsurance market if reinsurers of casualty or professional liability business look to exclude cyber in the future.

> "A catastrophic cyber event has the potential to cause a $3bn-$4bn loss, which could potentially wipe out an individual carrier"

Silent cyber

Some carriers have put enormous effort into looking at accumulation risk exposures to estimate the downside of reinsuring cyber risks, employing external modelling input to look at the accumulation input from a number of different angles.

Others still have a more rudimentary awareness of cyber risk, and are more focused on their affirmative books and less on the threat posed by so-called "silent" cyber risks, according to Synott.

Those with a greater exposure to silent cyber risks tend to add on endorsements to their standard insurance lines and will often reinsure those fully, he says.

Industry sources say that the most under-insured cyber risks relate to business interruption and contingent business interruption.

An insured with multiple suppliers exposes both their insurer and the cedant's reinsurer to business interruption and contingent business interruption risks.

If the original client lists their cloud storage provider as a named supplier and the provider suffers a breach then the original insured would be able to claim on their own losses, Synott says.

Issues arise when unnamed suppliers are impacted by a cyber event, as the insured's cyber policy might not respond to losses from those unnamed suppliers.

Stumbling blocks

Another key concern for (re)insurers is the possibility that a single cyber event could lead to claims across various standalone cyber policies – due in part to the interconnectedness of cyber risks – as well as spurring business interruption losses.

Sources have suggested that a catastrophic cyber event has the potential to cause a $3bn-$4bn loss, which could potentially wipe out an individual carrier, according to Chris Keegan, head of cyber liability at Beecher Carlson.

"All of the markets in the marketplace could be used to pay for a single incident," he says.

However, industry sources cite a lack of available, clean data as a major roadblock for modelling and gauging cyber prices.

"It's still early stages when it comes to modelling that will help reinsurers get some semblance of guidance on pricing," says Synott.

Cyber reinsurers complain that the lack of modelling data creates an environment where a lot of qualitative assessment still goes into pricing. And there's also the additional complication of overall aggregate accumulation, says Synott.

"Unlike property cat, cyber cat can't balance exposure, and the whole world is one cyber cat zone," he says.

Industry sources cite a lack of expertise in cyber reinsurance underwriting as a continuing issue for (re)insurance carriers in crafting policies and adjusting wording to cover for these exposures.

Keegan says that privacy cover has expanded over the years, but the industry still struggles with broadening coverage. "There's still some room for improvement from a liability standpoint," he says.

He also sees room for improvement on reputational damage cover, which has become more of a concern for underwriters as they see breaches such as Equifax affect the reputation of well-known companies.

However, industry sources are predicting that for meaningful change to occur in the industry, a major cyber attack is perhaps overdue.

"It's going to take a large event to really shape up the cyber reinsurance market and [make participants] take it seriously," Synott concludes.

AHEAD OF THE PACK

As the InsurTech start-up boom continues, reinsurers with an eye on the future are keen to get a piece of the action, finds **Bernard Goyder**

If you are selling liability insurance to someone, it might be useful to know if they have been up in front of a judge before.

When InsurTech start-ups like Next Insurance make underwriting decisions, therefore, they are not reliant on the client for information.

InsurTech companies are using data from every corner of the internet to make better underwriting choices, often double-checking information a client has given while they are at it.

It can be as simple as checking to see if a plumber buying professional indemnity cover has ever been sued before, by getting a robot to scan every public court record in a state.

But the technology has applications at every level of the industry, including reinsurance and retrocession.

Sending robots to scrape the internet for information is a feature of many of the newest generation of InsurTech companies, such as Next Insurance, Zesty out of California and Cytora in the UK.

"Anybody who is not working on this is missing out," says Sofya Pogreb, chief operating office of Next Insurance.

And reinsurers are paying close attention. Munich Re has been heavily involved in Next Insurance, as both an investor and capacity provider. Although the commercial insurance start-up mainly operates as an MGA, it is now a licensed insurer in the state of Delaware.

Using external data to help underwrite will have a massive impact on the future of insurance. But artificial intelligence (AI) is just one of a whole range of technologies set to transform insurance and reinsurance.

> "InsurTech companies are using data from every corner of the internet to make better underwriting choices, often double-checking information a client has given while they are at it"

From machine learning and voice recognition to blockchain and the fabled Internet of Things, tech is very much in fashion.

The iGeneration

Claude Yoder, chief innovation and product development officer at Guy Carpenter, helps reinsurers navigate the weird and wonderful world of InsurTech.

"There are currently more and more capabilities that are useful to reinsurers," he tells *IQ*.

Yoder's challenging task is to search through thousands of start-ups to find technologies that are useful to reinsurers.

"These start-ups don't necessarily put their hands up and say 'I'm an InsurTech'," he says.

The former Marsh executive, who moved to Guy Carpenter in September, reminds us that InsurTech has not been around very long.

"If you even look at the term 'InsurTech', it only really came onto the scene two to three years ago."

Yoder says he is now seeing InsurTech companies turn their focus from personal lines into other lines of business, with commercial P&C interest growing rapidly. His thesis is that a new generation of commercial insurance buyers will have very different expectations of carriers than their predecessors.

He argues carriers need to be ready for what he calls the iGeneration – digital natives born in the late 1990s and early 2000s – to join the job market.

"A lot of changes will have to occur in terms of how quickly interactions need to take place," he says. "That will greatly accelerate as this iPhone generation really becomes the insurance buyer of tomorrow."

> "The kind of AI technology being used by [InsurTech companies] is being closely monitored by reinsurers, who are getting a taste for InsurTech by providing funding and capacity to start-ups"

Problem solvers

For McKinsey consultant Valentino Ricciardi, InsurTech is about problem solving.

Ricciardi writes in 'The InsurTech Book', published this year, that InsurTech is about using technology to help fix problems across the insurance industry.

Zesty, a company that provides property data to insurers, has now caught the attention of reinsurers, because it does just that.

Zesty's co-founder and CEO Attila Toth believes bad data is costing the (re)insurance industry billions.

His start-up pulls together satellite imagery, light-aircraft photography and drone pictures to understand risks to property. He criticises big insurers that advertise at the Superbowl, but are still relying on customer inputs and maps drawn from the 1980s to underwrite.

Once he has the images, Toth uses AI to spot patterns in the pictures, and analyse them. Want to know where the nearest flammable bushes are to 742 Evergreen Terrace? Zesty can tell you.

Toth didn't start out in insurance. He was a McKinsey consultant before moving into the solar power industry. He was inspired to set up an InsurTech company when he was trying to buy home insurance and was asked what angle his roof sloped: a question that baffled him.

His pitch to reinsurers is that he can give data on thousands of properties aggregated together. So a reinsurer with a treaty containing a California wildfire exposure, for example, could evaluate its risk based on real-world data, rather than forms filled in by buyers and agents.

The same principles can also be applied to the commercial (re)insurance market.

Look, for example, at Cytora, a Cambridge University spin-off that counts XL Catlin and Starr Companies among its investors.

The firm's risk engine has data on every building and every company in a given area. Detailed data from local government fire reports, health and safety inspections, building materials and financial filings are added to an insurer's own loss records to provide a risk score.

Like Zesty, Cytora is a service provider to carriers, rather than an underwriter itself.

Cytora says this data has enabled one of its clients to improve its underwriting on its commercial property book to the point that its loss ratio has improved by 5 percent. It also says it has cut the costs of underwriting SME business by 8 percent for a UK carrier.

Cytora co-founder and CEO Richard Hartley says the company is also helping carriers to enter into new lines of businesses that they don't have loss data on.

The company offers a discount to carriers entering uncharted underwriting territory, but takes a 3-7.5 percent cut of new gross written premiums.

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Reinsurance backing

The kind of AI technology Next Insurance, Zesty and Cytora are using is being closely monitored by reinsurers, which are getting a taste for InsurTech by providing funding and capacity to start-ups.

Munich Re is probably ahead of the game: Munich Re Digital Partners provides venture funding and insurance capacity to a plethora of start-ups.

Swiss Re is also providing capacity to digital MGAs like Silicon Valley start-up Hippo.

And the Bermuda reinsurance market is getting in on the primary game. Arch recently agreed to provide paper to C-Quence, a financial and professional lines start-up founded by former AIG UK CEO Jacqueline McNamee. FloodFlash, a start-up founded by a pair of RMS cat modellers, has been incubated by Hamro Perks InsurTech Gateway for the last year and now has venture-capital funding and paper from Everest Re.

Reinsurers are not helping out start-ups just to be nice; carriers have an eye on the future.

As Adrian Jones, head of strategy and development at Scor Global P&C, puts it: "We want to create a customer and help them grow. Start-ups need a combination of expertise, reinsurance and equity, which reinsurers are able to provide in the right form for each stage of the client's development."

It makes sense for reinsurers to makes relatively small bets on InsurTech companies by taking an equity stake and supplying capacity.

The investment has management risk associated with it and some operating risk.

However, says Jones: "Owning 10 percent of a start-up is like having a 10 percent whole-account quota share that's not subject to annual renewal. And the stake could be sold for a capital gain, which in a sense is like having right of tenure at Lloyd's."

He thinks the market has room for more start-ups over time, even in markets currently crowded with InsurTech businesses, like renters' insurance.

Jones sees parallels between the InsurTech world and the dotcom boom of the late 1990s. The first technology companies to come into the market set the pace of change but did not always survive into the long term.

"The great tech-driven insurance companies of 20 years from now might not have been founded yet," says Jones. "Or they may be 100-year-old carriers who reinvent themselves. It's still very early."

> "Jones thinks the market has room for more start-ups over time, even in markets currently crowded with InsurTech businesses, like renters' insurance"

B3I TO START TRADING AT 1.1

The InsurTech blockchain consortium B3i will be used to trade live property cat excess of loss contracts on 1 January 2019.

Blockchain is a database for recording transactions, where details are recorded in multiple places at the same time.

A year on from launching the property cat technology at Monte Carlo, B3i CEO Paul Meeusen said the organisation has received "overwhelming interest" from industry participants.

Newly founded as a Swiss private company, B3i is in talks with insurers and brokers over a new funding round that they aim to close in autumn (late?) 2018.

"There's a strong interest from a broad range of companies to become shareholders of B3i. It allowed us to rethink our overall roadmap. We did our capital expenditure plans and realised we would need stronger funding," he said.

But B3i will only work if people use it. Like other trading platform initiatives, bringing liquidity to the platform is crucial.

"The willingness of partners to bring flow is something we've made very clear to investors," Meeusen said.

The consortium is putting insurers who commit to using the platform to cede their business at the front of the queue to join it.

The reinsurance brokers are also involved, he added. "We are in discussions with all of them on two aspects: the funding and the use of our first application."

Meeusen, a former head of treasury at Swiss Re, said the main advantage of blockchain is that the system provides a single version of the truth, making the kind of errors that can creep into paper-based reinsurance deals impossible.

"We are clear about the commission we pay to the broker, the cedant and premium paid by the cedant to the reinsurer," he said.

He argues that the way cedants buy reinsurance now can mean there is uncertainty over when a premium payment is actually meant to arrive.

"It's even more important a quarter later when a claim's emerged and there's a certain opaqueness around coverage of claims – what line of business, what perils, what time clauses, regional scope. All these things need to be very clearly commonly defined."

Meeusen likened being on the B3i blockchain network to a having a phone number or a web address.

"We need to ensure that the insurance industry speaks a common language," he said.

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UNIQUE SPECIALTIES

Rachel Dalton speaks to Ryan Specialty Group and Aon founder Pat Ryan about the need for something more than just entrepreneurial spirit when building an underwriting platform

The popularity of the managing general agent (MGA) model has yet to wane. The Managing General Agents' Association (MGAA) put the number of MGAs in the UK this summer at around 300, bringing in £10bn in gross written premium.

In the past year, a number of firms have entered the MGA space. Willis Towers Watson backed former Acappella CEO David Thomas in his transatlantic venture, Innovisk. Meanwhile, rival Marsh & McLennan Companies, through programme manager Victor O Shinnerer & Co, acquired the MGA business of Icat, and Aon has its MGA business, Aon Underwriting Managers.

Outside the big players, smaller MGA operations are starting up or growing. Nephila-backed MGA platform Volante secured a $900mn multi-class capacity deal with three global carriers in June. In May, it emerged that Richard Brindle's Fidelis attracted two new MGAs onto its Pine Walk Capital incubator platform. Berkshire Hathaway backed Texas-based managing agency Kemah Capital, run by former PartnerRe head of direct and facultative Dom Tobey. Acquinex, with capacity from Arch, launched in August last year, while Towergate unveiled a London market specialty MGA in the same month.

In the US, the picture is similar. The number of active MGAs has increased by 35 percent to 610 between 2011 and 2015, while the amount of premium written directly by US MGAs increased by 27 percent to $41.6bn over the same period (see charts on pages 23 and 24).

Disciplined strategy

The growth of MGAs is a by-product of the soft market, as carriers and brokers consolidate and individuals look to strike out on their own, according to industry veteran Pat Ryan.

However, entrepreneurial spirit alone is not enough to sustain a business, he adds.

"You read about companies that are backing start-ups and giving equity to underwriters and that's all fine, but there has to be a reason why that underwriter is needed," he explains.

"It can't be just because they want to be an entrepreneur, they want to own equity and they have a lot of friends who have given them business over the years. That is not enough to build a sizeable business."

And he should know. Ryan's career has focused on growing sizeable businesses. He is the founder and was formerly the chairman and CEO of Aon, the broking giant that was formed following a merger in 1982 between his company Ryan Insurance Group and W Clement Stone-headed Combined International Corporation. After spending 41 years at the helm of Aon, developing it into the behemoth it is today, Ryan retired in 2008, and two years later founded Ryan Specialty Group (RSG), the company he now leads as chairman and CEO.

RSG specialises in wholesale brokerage, managing general underwriter (MGU)/MGA underwriting management and other specialty services to agents, brokers and carriers. Since its foundation, RSG has bought 31 businesses and launched 13 start-ups.

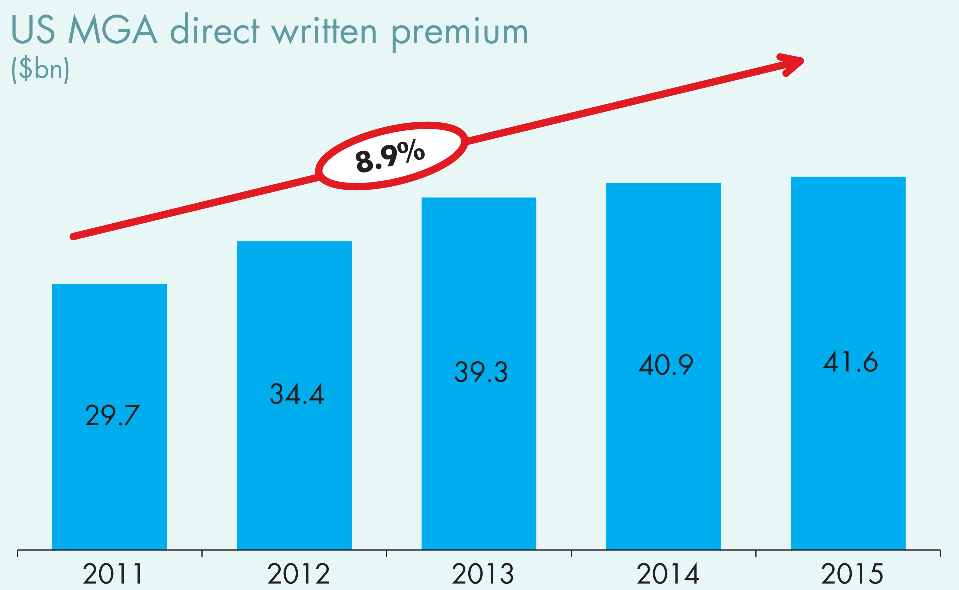
"We achieved scale, in both our underwriting and broking divisions; significant scale," says Ryan.

"We're the third-largest wholesale broker in the US, and the fourth-largest MGU, but, in terms of sizeable businesses, we're growing much faster than anyone else."

Accordingly, RSG's M&A strategy follows a "disciplined pattern", Ryan says.

"That's finding companies that we fit together with culturally, that we fit together with strategically, and where we're able to establish an agreement where both sides get a good, fair deal," he says.

"I'm very proud of the fact that, of those 31 acquisitions, 31 of the principals are still with us, which means that people sold their business to us, with the intent to stay with it and help grow it and see what they had built coming to fruition because of being part of a bigger platform."



Sources: SNL Financial, NAICS, Individual 10 K filings, AXCO, StoneRidge Advisors, Inpoint Analysis

> "You read about companies that are backing start-ups and giving equity to underwriters and that's all fine, but there has to be a reason why that underwriter is needed"

Spoke and hub

Ryan says RSG is "agnostic" about whether it buys broking or underwriting businesses, however. To join the RSG stable, firms must have "unique specialties" and the potential to help the company expand its scope.

"When I say 'expand scope', that often means new product lines and new geography," says Ryan.

"If you appropriately expand the scope, the scale will follow. As you expand the scope, more opportunities fall out of that."

He points to RSG's acquisition of Navigators' insurance agencies in Sweden and Denmark in January last year as an example.

"We established ourselves in the Nordic countries, and with that success in professional lines came the opportunity to expand into other lines. We will be doing the same thing in other parts of Europe," he says.

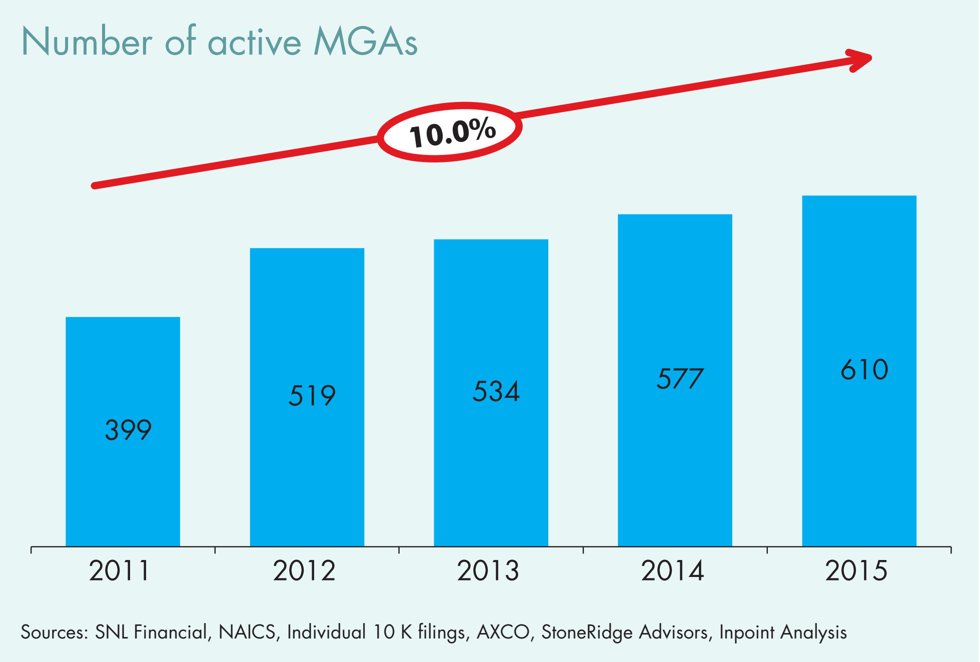
"In our US wholesale business, we started with what we called a hub strategy, where we opened up de novo in the major metropolitan areas in the US: Chicago, New York, Houston, Dallas, LA and San Francisco."

Within six years, RSG began developing 'spokes' around these major hubs, Ryan explains.

"We are moving into markets that are smaller-sized cities. There are multiple cities in many of those states that are of interest," he says.

Ryan adds that the focus in the US had been on expanding its binding authority businesses, having now obtained binding authorities in 50 states.

Continued on page 24



"The binding authority business also has the added benefit of being stickier business; it renews at a higher rate. That size risk tends to stay with the retail broker longer, and doesn't get moved by the retail broker through markets as often as the larger risks do," he says.

Part of RSG's focus on binding authority business is to reduce costs through the use of technology.

"Binding authority business is going to be the first to consolidate the use of electronic trading," says Ryan, who adds that RSG is already investing in the technology.

Specialise to survive

Given his long career in the sector, Ryan is well aware of the particular challenges that MGAs or MGUs bring. He argues that specialisation and a strong focus on MGAs' fiduciary duty to carriers are necessary in order for them to survive.

"MGAs have burned markets; there's no doubt about that," he says. "If you want to be in that business long-term, you have to start with the fact that you're a custodian, you have a fiscal responsibility and moral responsibility to the capital provider to produce profitable business for them. Your first allegiance cannot be the growth; it has to be the profitability."

Growth is necessary, he says, but this can only be done by striving to increase the amount of profitable business on the books and not by underwriting risks for the sake of achieving volume.

"We are zealots on that and as a result we have very strong support from insurance carriers giving us the pen."

> "MGAs have burned markets; there's no doubt about that. If you want to be in that business long-term, you have to start with the fact that you're a custodian, you have a fiscal responsibility"

While RSG has bought a number of businesses with long histories, Ryan reiterates that the lifespan of an MGA is often "under ten years".

The point at which MGAs fail is when "there hasn't been a reason why people should not deal directly with the insurance carrier", he adds. "That really comes from developing an expertise in a product and/or an industry. We have specialists in construction, healthcare, property and professional lines, and these people all have different skills and, in some cases, they are very strong go-to markets because there aren't that many competitors."

Retail/wholesale conflict

Ryan maintains his long-held belief that brokers that have both a retail and a wholesale operation face a fundamental conflict, noting that in the past six years a number of retailers have disposed of their wholesale operations.

"There are three significant retailers in the US that own wholesalers and the others have all either never had one or have disposed of it. Those three would argue passionately that we're making too much out of that conflict," he says.

"Two of the big three brokers are heavily focused on binding authority. In binding authority, the smaller broker doesn't really feel the same competitive conflict issue that larger brokers do. But outside of their binding business, when you own a wholesaler, it's hard to expect that your competition is going to be anxious to feed you the business."

The next phase for RSG is to create a reinsurer to offer capacity to the primary paper providers of its MGUs – a plan that was revealed by sister publication *The Insurance Insider* in June.

Ryan confirms the plan is under way, albeit, he says, it is "in the very early stages".

The new project is about "eating your own cooking" in terms of sharing interests with carriers, he adds.

"We've had carriers who have asked us to get what they would call a better alignment of interest with them. We are at risk with them and ergo they are more comfortable that we're not going to let growth get in the way of profitability," he explains.

He says RSG's dealings with carriers more widely will not be coloured by whether or not they support the reinsurance MGU.

"We will say: 'If you don't want to participate, we're still going to do business with you.' There's going to be no discrimination in that," he concludes.

CAPITAL CORNUCOPIA

For latecomers hoping to climb aboard the ILS bandwagon, innovation is key, writes *Trading Risk*'s **Fiona Robertson**, but the benefits of utilising third-party capital could be plentiful

The saying "If you can't beat 'em, join 'em" is an apt description for the reinsurance market's approach to the ILS sector in 2018.

Many carriers have already come to this conclusion and have built up sizeable asset management platforms in the past five years.

But now those which were among the holdouts have been left reeling from the shock of catastrophe rates that have not brought payback after one of the worst loss years on record.

As a result – even though there was no need for additional capacity – there has been a spike in new launches of sidecar vehicles and renewed interest in earning fee income at carriers that had previously showed little interest in having an ILS strategy.

But is it too late for them to catch up? The consensus seems to be "no" – as long as they are offering a unique strategy.

Aon Securities CEO Paul Schultz says reinsurers chasing ILS capital may find it is now difficult to get buy-in from third-party capital for a "me-too" strategy. But reinsurers' ILS strategies are still likely to be anchored in property cat markets in the near term, he adds.

"The capital providers have shown the most interest in this area," he explains.

Given the syndicated nature of the cat treaty space, with risk spread evenly throughout the market, it isn't necessarily easy for reinsurers to deliver truly unique cat-based propositions. But Schultz says it is possible – for example, by picking out geographical niches.

Investors place a lot of weight on track record and scale, so competing with longer-established managers on the standard catastrophe and collateralised reinsurance model will be a hard win, points out Richard Lowther, ILS chief operating officer at Hiscox Re & ILS.

Even if reinsurers have long underwriting records in these markets, the key point is whether that can be presented in a format that is useful to investors. Does it mirror the closely defined portfolio that they may be offered by a reinsurer, for example?

RMS client director Jin Shah says the firm has seen a wide range of data quality when it comes to submissions proffered to sidecar investors. In

some cases, exposure information might be limited to a handful of exceedance probability curves.

"When information is less detailed or precise, it is natural that investors will price in some greater uncertainty," he notes. "We are increasingly seeing ILS clients wanting to actively manage exposure data."

Incorporating detail on all fee structures and commissions in a clear way, including accounting for fees such as brokerage, can help give investors a more accurate perspective on returns, he adds.

One of the newer reinsurer entrants to the ILS market is Neon. According to Mark Gibson, who heads up the newly launched Neon Capital Markets: "Tremendous competitive forces are building up, but entry is not difficult, and it isn't too late."

A quota share sidecar is a good starting point for reinsurers hoping to manage third-party capital, and he suggests beginning by sourcing support for a key part of the company's portfolio.

"They should identify sticky, core business which is predictable in volume for the sponsor company, and share that with investors as a first step," he says.

From there, a reinsurer will be better positioned to discuss managing more of an investor's capital to underwrite market-facing business.

ILS or retro capital?

The move to managing market-facing business is something that far fewer reinsurers have undertaken.

A market-facing vehicle is one that has a portfolio built specifically for its investors, and which transacts directly with protection buyers, rather than standing behind a reinsurer and taking a slice of its pre-existing portfolio. Examples include Lancashire's Kinesis and the AlphaCat funds at Validus.

Each model carries its own challenges, however. Investors will always be alert to the risk of adverse selection (or receiving less profitable business than a reinsurer keeps for its own balance sheet). At Hiscox Re & ILS, Lowther says the approach has been to face this perception "head-on", setting up "strong governance, transparency and independent oversight over critical functions".

But the advantage that reinsurers may be able to play on is access to the parent's rated balance sheet.

"Our investor clients benefit from the capital efficiency and granular, diversified portfolios that are built in a cost-effective manner through a rated balance sheet," Lowther says.

From the perspective of protection buyers, each model of delivering third-party capital can work well if articulated clearly, adds Aon's Schultz. "I don't think one size has to fit all," he says.

Continued on page 28

Reinsurers and ILS strategies

In-house asset managers writing direct business for investors

Company	AuM ($mn)	Strategies offered
AlphaCat Managers (Validus)	3,491	Collateralised reinsurance funds (high/low risk) and tracker-style cat bond fund
Renaissance Underwriting Managers (RenRe)	2,757	Catastrophe book mimicking RenRe portfolio (DaVinci); collateralised retro/reinsurance funds; cat bond fund
Hiscox Re ILS (Hiscox)	1,600	Diversified funds taking business fronted by Hiscox; collateralised reinsurance funds and insurance sidecar
Scor Investment Partners	1445	Collateralised reinsurance funds
Tokio Marine Asset Management	750-775	Cat bond focus
Kinesis (Lancashire)	500	Multi-class retro/reinsurance
New Ocean (XL)	450	Collateralised reinsurance (regional US focus)
Blue Capital (Sompo Endurance)	350	Collateralised reinsurance and quota share of XL Re
Sussex Re (Brit)	100	Collateralised reinsurance and quota share of Brit
Sumitomo Mitsui Asset Management (Tokyo)	95	Cat bond focus

Source: *Trading Risk*

Quota share managers sharing risk with investors indirectly

Company	Size ($mn)	Year launched	Owning external managers
Everest Re – Mt Logan	1,134	2013	MS Amlin – Leadenhall (75% stake)
Axis Ventures – private deals	1,045		Allied World – Aeolus (small undisclosed stake)
Munich Re – Eden Re & Leo Re (private PGGM vehicle)	700	2015	TransRe – Pillar Capital
Liberty Mutual – Limestone	700	2017	
Aspen Re – Peregrine & others	650	2014	
Hannover Re – K	600	2008	
Arch Underwriters - private deals	600		
Swiss Re – Sector Re	530	2007	
TransRe – Pangaea Re & others	500		
PartnerRe – LRe & others	195	2013	
Brit – Versutus	187	2015	
Ace – Altair	95	2013	
Chaucer – Thopas Re	95	2018	
Neon – NCM Re	72	2018	
Hamilton – Turing Re	65	2017	
Sompo- Blue Lotus	62	2018	
Amlin – Viribus Re	60	2018	
Fidelis - Socium Re	50	2018	
Argo - Harambee	n/d	2013	

Source: *Trading Risk*

Regardless of which structure is employed, there is a bigger philosophical question surrounding reinsurers and their use of ILS capital – are they truly competing as asset managers, or are they simply loading up on retrocession?

It is not always easy to distinguish between a simple retro sidecar and a third-party asset management play. Which vehicles actually have the infrastructure in place to act as fiduciary managers of investor capital – and which are merely asking investors to enter a transaction on a buyer-beware basis?

Consider vehicles operated by some of the continental carriers, for example: Munich Re's Eden Re and Hannover Re's K sidecar.

The K vehicle is the longest running, but Hannover Re has never made any pretence of describing it as anything more than a retro sidecar – one more likely to be placed with ILS managers than to compete with them for institutional investor mandates. (The carrier has set up and seeded funds run by a separate entity, Leine Re, which is open to external investors, but as yet without fundraising success.)

Munich Re, on the other hand, has won an allocation from one of the largest ILS investors, PGGM, for Eden Re. Yet it keeps the sidecar well out of the spotlight with protection buyers, unlike market-facing vehicles such as AlphaCat or DaVinci that appear on subscription market programmes in their own right.

Indeed, Lowther suggests that many reinsurers "simply don't want to be asset managers".

"[They] see ILS simply as transacting with ILS funds to source capacity," he adds.

Looking at some of these reinsurer platforms, it is notable that a couple of major investors provide the bulk of their capacity.

The fund of funds approach

One firm has been key in enabling this kind of ILS growth in the past five years. Since its launch in 2013, Stone Ridge Asset Management quickly built up its asset base to become a top 10 ILS manager with nearly $7bn of assets under management as of April 2018.

Unlike the early pioneering ILS managers, it has eschewed direct underwriting competition alongside reinsurers and has chosen to pursue more of a fund-of-funds style approach to building its ILS portfolio – investing heavily with selected reinsurers and fairly widely across the spectrum of sidecars.

Axis, for example, has $665mn of funds from Stone Ridge, with sidecar vehicle Mt Logan drawing $671mn of its $1.1bn total capacity from the manager.

Looking at some of the recent launches in the ILS sphere it appears that this trend could play out further. A number of private banks and wealth advisory firms in the US have set up new ILS vehicles in the past 18 months. While many have chosen ILS managers to deploy capital on their behalf, reinsurers could well make moves to benefit from these kinds of feeder fund structures.

"Scale – both of a reinsurer and its sidecar – may be crucial when it comes to building ILS platforms"

However, with this kind of arrangement, where a reinsurer is not dealing directly with the ultimate source of third-party wealth, Lowther raises a question over whether they will achieve the same benefit as reinsurer managers that are able to directly attract institutional capital.

"The closer the reinsurer can get to the real end investor, the more complementary and stable the capacity ultimately will be," he says.

Measuring the benefits

Ultimately, before chasing headlong after third-party capital, the question a reinsurer needs to ask when creating a new ILS strategy is what's in it for them?

The clearest driver, in these days of challenged returns, is fee income. However, unless a reinsurer is using ILS capital to boost its overall top line, then this will come at the cost of more lucrative underwriting income on premium that would otherwise have been kept by the carrier.

But fees have the advantage of being risk-free income, "which is handy in a tough underwriting environment", as Gibson points out. "The impact goes directly to the bottom line."

However, reinsurers have to maintain quality underwriting returns for these new investors, he notes.

"The fee income will quickly disappear if the underwriting is loss-making."

Meanwhile, scale – both of a reinsurer and its sidecar – may be crucial when it comes to building ILS platforms, going by analysis done by Standard & Poor's (S&P) for this publication.

The rating agency considered the example of a global reinsurer with $5bn of equity before and after setting up a $120mn sidecar. It used five-year average data covering the period from 2010-2015 from its peer group of reinsurers to set the carrier's loss ratio and expense ratio.

With these benchmark data points to hand, and assuming annual average catastrophe losses of $500mn (calculated by modelling agency RMS, using a scaled-down version of its industry exposure database), it worked backwards to establish the firm's premium income, combined ratio and return on equity (RoE). It assumed around $800mn related to cat premiums, based on average cat loss portfolio data, and that the sidecar took a 10 percent quota share of this book.

It assumed that the reinsurer earned a 20 percent ceding commission on premiums transferred to the quota share vehicle, and also factored in the benefit of a 10 percent profit commission on the sidecar's net income after deducting its share of average losses.

In the first post-sidecar scenario, the results showed that if the reinsurer did not lift its top line and reduced its shareholder equity by the $120mn raised from collateralised reinsurance, the post-sidecar average loss scenario actually led its RoE to slip by 1 basis point, as the fee income was not enough to offset the reduced premium earnings. But assuming top-line growth and stable equity, with no impact on earned premium from the $80mn cession to the sidecar, the RoE would rise by 88 basis points.

However, S&P associate director Olivier Karusisi said that from its perspective, the most interesting benefit from a sidecar compared to traditional reinsurance was the reduction to counterparty risk from raising collateralised retrocession. "It's beneficial from a capital relief perspective."

Moreover, if cat premiums were to soften then a reinsurer would be able to share more losses with a sidecar vehicle.

"Hence, depending on how cat pricing evolves, it is more or less beneficial to set up a sidecar," Karusisi added.

The agency also noted that most reinsurers have used sidecars to amplify their top-line premium in recent years, without taking more net risk.

Beyond the numbers

That said, there are more things to consider than just the financial impact of managing ILS capital.

Strategic benefits include increased relevance to buyers from being able to deploy larger line sizes and having quick access to capacity in a post-loss scenario, says Lowther.

But to gain these benefits, reinsurers would have to build more than just a mini-sized sidecar, he adds. "Without scale, it's only giving fee income."

Neon's Gibson frames the strategic issue somewhat differently, looking at the breadth of the ILS incursion into the reinsurance market.

"If we were to ignore it, we would be deliberately restricting our areas of operations," he says.

Schultz suggests that perhaps some of the benefits from using ILS capital have yet to be created.

"Cedants are looking for holistic solutions, and using ILS capital enables more innovation," he says. "We have just scratched that surface on this."

And Lowther's parting words of wisdom for reinsurers seeking to emulate the likes of Validus or Hiscox?

"Play to their strengths, look for products that will be complementary and leverage existing expertise," he says. "Be prepared to make the necessary investment to build a proper asset management platform. You want to give investors comfort over critical areas of conflict mitigation, governance, valuations [and] compliance."

S&P sidecar analysis

	Reinsurer before sidecar	After – no top line growth		After – top line growth	
	Amount ($mn)	Amount ($mn)	Notes	Amount ($mn)	Notes
P&C premiums (excluding cat)	3,961.9				
Cat premiums	800.0				
Premiums ceded to sidecar	-	80.0		80.0	
Sidecar ceding commission		16.0		16.0	
Net earned premiums	4,761.9	4,697.9	NEP dips by 1.34%	4,777.9	NEP up 0.3%
P&C Losses (excluding cat)	2,514.3				
Cat losses	500.0				
Claims recovered from reinsurance	-	50.0			
Net claims	3,014.3	2,964.3	Claims dip by 1.66%	2,964.3	Claims dip by 1.66%
Operating expenses	1,400.0				
Profit commission income		1.4		1.4	
Technical result	347.6	335.0	Down 3.6%	415.0	Up 19%
Investment income	160.0				
Profit before tax	507.6	495.0			
Net income	330.0	321.8	Down 2.5%	373.8	Up 13%
Shareholders' equity	5,000	4,880		5,000	
Performance ratios (%)					
Expense ratio	29.4				
P&C loss ratio (excluding cat)	52.8				
Cat loss ratio	10.5				
Combined ratio	92.7	92.9		91.34	
RoE	6.6	6.59	Down by 1 basis point	7.48	Up by 88 basis points

Assumptions: Sidecar capacity –$120mn; max loss ratio 150% assuming reinsurer "takes back the tail"; Fee structure – 20% ceding commission; 10% profit commission
Source: Standard & Poor's, RMS

Anthony Freeman assesses the long-term potential of industry-wide digitisation and standardisation of (re)insurance administration processing

THE RÜSCHLIKON REVOLUTION

It has been evident for some time that much of today's global (re)insurance premium is being wasted – an issue numerous speakers at industry events have highlighted.

At the same time, today's economic climate presents (re)insurers with a number of challenges: the low-interest environment; greater price transparency; and customer cost consciousness.

As a result, it has been reported that the industry's profitability is currently barely above the cost of equity.

According to a McKinsey & Company report, titled "Successfully reducing insurance operating costs", there are significant cost differences within the sector.

For example, the difference in operational costs between top-quartile players and those at the bottom of the stack is consistently higher than 60 percent across every business function. In some cases, bottom-quartile players' unit costs are almost more than twice those of top-tier players.

A market survey compiled by the Institute of Insurance Economics, University of St Gallen titled 'The Rüschlikon Initiative' focuses on both the potential and market acceptance of an electronic platform to facilitate (re)insurance administration.

The survey findings illustrate that "current intercompany reinsurance administration is both people- and paper-intensive. Although some electronic data exchange takes place, most communication is characterised by a low degree of standardisation and digitisation".

The survey goes on: "Data are primarily exchanged by means of spreadsheets via electronic mail; reconciliation and payment are done manually. Within this context, market participants endorse the Rüschlikon Initiative's proposal on a strategic level by recognising the long-term potential of digitisation and standardisation."

Frictional costs

Organisations such as the Association for Cooperative Operations Research and Development (ACORD) point to the unproductive frictional costs of administrative processes between broker, insurer, reinsurer and retrocessionnaire, which need to be addressed if the industry wants to avoid potential emerging market players coming along and stealing its lunch.

The race is therefore on to identify and implement industry-wide formats and processes that can provide electronic global messaging solutions to reduce the costs of data exchange while enhancing data granularity.

A number of solution providers have gateway messaging products but there is currently a real dearth of businesses that can integrate claims and underwriting systems into a global insurance data messaging facility that global carriers can control.

That is why I believe there is a real opportunity to be the first InsurTech provider to go to market that integrates claims and underwriting data.

Insurance companies are telling me that the ability to write back to the central market systems, or communicate peer to peer, via whatever claims or underwriting portal they use, is becoming a priority.

The challenge is to provide messaging solutions that enable managing agents – and their clients – to communicate on a global platform while having the ability to receive data in a structured standard format against which they can be allowed to

> "The race is on to identify and implement industry-wide formats and processes that can provide electronic global messaging solutions to reduce the costs of data exchange while enhancing data granularity"

> The challenge is to provide messaging solutions that enable managing agents – and their clients – to communicate on a global platform while having the ability to receive data in a structured standard format

build business processes.

Underwriters, claims handlers, broking houses and agents sending insurance messages need to communicate more efficiently with their insurance peers.

It is becoming increasingly important for trading companies in the insurance market to exchange data electronically.

Effective communication

A number of technical initiatives operate today to enable effective communication of data.

A few service providers, DOCOsoft among them, have already developed solutions for this market that comply with the emerging standards and regulations.

DOCOsoft, for example, currently supports: ACORD-certified document repository interface (DRI); ACORD global reinsurance and large commercial (GRLC) messaging (electronic back office transactions and electronic claims office transactions, or EBOT and ECOT); and the LMA supported Write-Back messaging.

DOCOsoft is also part of the Rüschlikon Initiative, connecting leading players of the (re)insurance industry to advanced back office processes – such as technical accounting, claims and settlement – using the ACORD GRLC standards.

Rüschlikon requires all brokers and (re)insurers to commit to the common principles and standard messages and processes specified in the Global (Re)insurance Best Practices – Accounting, Claims and Settlement.

The Best Practice Guide also suggests target-processing times to which firms should aspire, to ensure that trading partners get the most from their implementations. There are clear business benefits to being involved with the initiative.

Once insurance companies start exchanging EBOT and ECOT messages, their organisation will benefit from greatly reduced costs, timescales and errors. They and their clients will also benefit from faster payment cycles and improved data quality. In addition, joining the Rüschlikon Initiative demonstrates insurance companies' support for the industry, their peers and their partners.

EBOT and ECOT are ACORD standard specifications. They document the business data and rules required for conducting electronic business conversations from system to system.

Some companies report that, on average, these benefits have amounted to 30 percent lower administrative costs, 30 percent faster premium settlement, and 40 percent faster claims settlement than businesses did without using Rüschlikon.

Certification ensures that set-up times between partners are kept to a minimum and companies can start to obtain benefits from reliable messaging as soon as possible.

It also ensures that everyone is using the same standards and that there is no burden on companies with established processes to provide support to newer implementers.

Over time, ACORD messages evolve, and from time to time re-certification may be required, so these benefits aren't just limited to those joining Rüschlikon for the first time.

One-stop shop

To summarise, I envisage a messaging global one-stop shop; connecting our central systems to insurers, while also allowing for insurer-to-insurer, broker-to-insurer and customer-to-insurer interactions.

Our vision is for this frictionless and scaleable platform to be built on the back of ACORD standards, enabling simplified business-to-business (B2B) transfer. It will handle "synchronous" and "asynchronous" communication, B2B and business-to-consumer full peer-to-peer messaging.

Full integration with claims systems and underwriting systems is a key follow-on benefit, offering a major upgrade on electronic data interchange, with significant time savings. Participating parties can also expect a higher level of system security.

We will also remove multiple re-keying, automate manual processing, and reduce errors and omissions risks.

This allows the agreement of claims more efficiently, while processing 24/7 claims and policy access. (Re)insurance clients require scaleable solutions as their business develops and message volumes grow.

To conclude, the ultimate endgame is a platform that improves the flow of insurance information between systems and partners, enhances data quality and transparency, increases efficiency and market scope and reduces operating costs, i.e. straight through processing.

DOCOsoft has demonstrated that it is at the heart of this new world of global insurance messaging capability when we achieved official 2016-10 ECOT/EBOT ACORD certification earlier this year. This means that our Gateway is officially approved to take global claims and policy messages, as part of the global Rüschlikon revolution.

We look forward to supporting the Rüschlikon mission statement, which is to reshape the (re)insurance industry by designing and implementing processes that reduce operational cost and enhance client service.

ANTHONY FREEMAN is head of development at DOCOsoft

THE BEST-LAID PLANS…

In light of continuing uncertainty over the UK's exit from the EU, **Peter Allen** considers the government's Brexit white paper and its implications for the insurance market

What is a white paper anyway? It's a formal statement of the government's position on a matter of policy. It's not a consultation paper – that's a green paper.

Generally, governments are reluctant to row back from the positions taken in white papers, which is why the UK Government's Brexit white paper is particularly controversial and has been followed by resignations.

So what does this one say about the insurance market post-Brexit?

It says four main things: that the UK wants to be able to diverge from the EU in terms of financial services regulation; that passporting will no longer be possible and there will be no right of market access in either direction; that the UK will instead seek an enhanced equivalence regime that addresses some of the problems of the existing EU equivalence regimes and gives limited market access into the EU; and that the starting position, at 1 January 2021, will be simply one of equivalence.

Let's look at each of these in turn.

Regulatory alignment

The government is not in favour of regulatory alignment. The main reason given is that because of the importance of financial services to financial stability, the UK may need to be able to impose higher than global standards.

Intriguingly, it also opens the possibility of relaxation in the other direction, with the statement that "the UK market contains products and business models that are different to those found elsewhere in the EU, and regulation would need to reflect those differences". This is not true of the current regulatory regime, where the UK must always follow EU directives.

Passporting

Passporting isn't going to be possible. The paper does not lay out an explicit logical connection between the first point and the second, but the implication is that the UK Government has concluded that the EU will not allow passporting post-Brexit, except under circumstances where the UK accepts full regulatory alignment, which the Government doesn't want.

This is also logically consistent with the position being taken in the paper on goods, where the government is prepared to accept a "common rulebook" and is asking for full market access in return.

Enhanced equivalence

So what does the insurance market get instead? If it can be negotiated, an enhanced equivalence regime.

The paper notes that the existing EU equivalence regimes are flawed. The main reason comes last: "The existing regimes do not provide for phased adjustments and careful management of the impact of changes." This is something of an understatement, given that the EU can withdraw equivalence at 30 days' notice. So, the proposal is that an enhanced equivalence regime is negotiated.

It is fair to say that, at this point, the language in the paper becomes somewhat abstruse and it is difficult to follow precisely what is being said or asked for. This may reflect intellectual uncertainty on the part of the writers or, more likely, a degree of disagreement about what is desirable or negotiable.

It may well also reflect a desire to keep options open during negotiation. In essence, it is a wish list of possibly negotiated outcomes.

One intriguing possibility is that for "the most important international financial services [sub-sectors]... those that generate the greatest economies of scale and scope" the new arrangement might provide for a cross-border provision. The paper is silent on which sub-sectors might be prioritised in this way.

Transition period

So are there implications for the transition or implementation period? Not directly, except in one important respect. The white paper makes no suggested changes to the transition, or implementation period, which is planned to run from 29 March 2019 to 31 December 2020.

The position during that period is as follows. The EU Council issued guidelines on 29 January 2018 which set out its position in some detail. In particular, the whole of EU law and any changes to it will apply to the UK; the UK stays in the single market and the customs union; and the full competence of EU institutions is preserved.

The UK position had been summarised in a speech by former Secretary of State for Exiting the European Union David Davis two days earlier and was remarkably similar: "Both sides must continue to follow the same, stable set of laws and rules, without compromising the integrity of the single market, and the customs union to which we will maintain access on current terms; maintaining the same regulations across all sectors of the economy – from agriculture to aviation, transport to financial services ... in keeping with the existing structure of EU rules that will allow a strictly time-limited role for the European Court of Justice during that period. During this ... period, people will of course be able to travel between the UK and EU to live and work."

Both these positions were incorporated in the text of the Withdrawal Agreement, which was issued at the end of March 2018, with the parts referring to the transition period highlighted in green to indicate that they were agreed. So essentially, at a practical level, it seems likely that very little changes.

However, this all assumes that the Withdrawal Agreement is actually ratified. This is the respect in which the white paper may affect the transition or implementation period.

The paper repeats the EU's mantra that "nothing is agreed until everything is agreed", and specifies that "the Withdrawal Agreement should include an explicit commitment by both parties to finalise these legal agreements as soon as possible in accordance with the parameters set out".

In other words, the UK Government is expecting that the matters covered in the paper are broadly concluded before the Withdrawal Agreement is signed, even though the actual future agreements cannot be concluded until after the UK has ceased to be a member.

This obviously increases the risk that nothing will be agreed, especially since it is difficult to characterise the UK Government's approach as anything other than "cherry-picking", something the EU has been long opposed to.

Industry reaction

So how has the paper gone down with the industry? So far, badly. CityUK said: "Mutual recognition [of each other's regulatory regimes] would have been the best [approach] and it is regrettable and frustrating that it has been dropped before getting to the negotiating table." The outgoing CEO of Lloyd's has said that the proposals are "very disappointing" and "do not provide the certainty we are looking for".

She reaffirmed plans for Lloyd's in Brussels.

It is quite right that the paper does not provide certainty – it is only clear about what the UK Government does not want. On the question of what is to replace it, it provides a list of desiderata but not a clear picture. However, these reactions are not directly addressing a major problem: the political question of whether market access without regulatory alignment was ever really a runner.

The basic problem is "cakeism": the hope that we can get the best of both worlds overcoming the practical fact that we have to choose.

Was it ever likely that the EU would concede full market access on the basis of mutual recognition of regulatory regimes which can, by definition, diverge? The UK Government has clearly concluded that it won't.

And what the industry has then failed to answer is the question of whether, forced to choose, they would prefer regulatory flexibility or market access. The London Market Group's proposals issued in November 2017, for example, did not address this question.

So what does this mean for clients? As the outgoing CEO of Lloyd's correctly observes, the white paper is the signal that businesses must now plan and execute those plans on the basis that there is going to be no agreement that preserves market access as we know it.

In the worst case, this will happen from March 2019, because the unintended result of the UK Government's position is that no agreement is reached at all. But the far more likely outcome is that some agreement is reached so the implementation or transitional period will operate until 31 December 2020.

However, not only is it unclear what can be negotiated but it is also clear that whatever is negotiated will not match up to the level of market access enjoyed under the current passporting regime.

This vindicates those clients who have already started implementing their plans for an onshore entity and our advice to all clients that they should have a clear and comprehensive contingency plan.

Those contingency plans should now be put into effect.

PETER ALLEN
is insurance partner at Moore Stephens

MAKE ME API

APIs offer the ability for (re)insurers to create truly bespoke user interactions without the hassle of disrupting existing workflow, says Jason Futers

The insurance industry is in many ways a victim of its own success. It sits upon an infrastructure of systems, technologies, processes and workflows which have stood firm for decades and enabled many carriers to prosper. However, such rigid foundations mean that when change happens, and particularly the speed and scale of change witnessed in recent years, its ability to respond at pace is severely curtailed.

One particularly weak link in the insurance chain is data transfer. The degradation of data that occurs as it is transferred from original source to ultimate capital provider means that in many cases it is almost unusable when it reaches its destination.

Passing through multiple teams and systems, often altered to fit specific use cases or technologies, the original integrity is quickly lost.

Attempting to alter ingrained data workflows can be a huge task, particularly when such workflows span multiple organisations. So, at a basic level, how can we at least ensure data consistency at all stages in the process?

That is where APIs (application programming interfaces) enter the chain. APIs provide a transformational tool which essentially opens up the underlying technology of a system or systems.

Providing that open access means that API users can create a bespoke form of interaction with the underlying infrastructure or the data contained within it, which overcomes the limitations of existing workflows and user interfaces and enables a solution tailored to the needs of the particular company or their client.

Placing APIs into the exposure data context, the user-specific interaction that they facilitate can generate huge benefits across modelling and exposure management workflows.

As mentioned, these workflows and the related user interfaces require significant time and investment to alter. Using APIs, the underlying workings remain unchanged, but what does change is the interaction with the data that flows through it.

What APIs facilitate is the ability for all parties in the chain, whether that be a broker, an underwriter or an actuary, to interact with the data in its original state, rather than a version of that data that has been transformed as it is transferred along the chain.

While the existing processes used by the individual parties can remain unchanged, what has changed is that everyone is accessing the same data.

From day one, the Insurdata Platform was built as an API facility providing access to high-resolution building-level exposure data.

Our APIs plug directly into the existing workflows and technologies of insurers and reinsurer and, with our Microsoft Excel add-in component, mean that data analysis processes for most companies can be maintained, but are now accessing better-quality, consistent exposure data at all stages, rather than data tarnished in the transfer process.

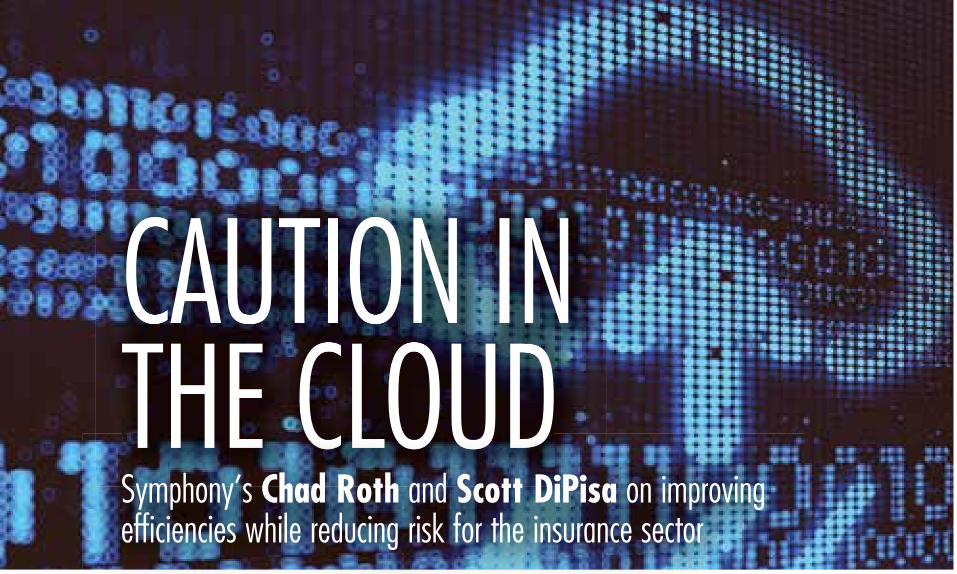
The API model effectively empowers users of a particular technology to make it better. At Insurdata, we are an ideas-driven company, but that does not mean those ideas only come from within. We have created a platform upon which other organisations can build their own new and exciting ways of interacting with our technology, using our SDKs (software development kits).

That is the real value of the API approach – you can always keep building upon that foundational technology layer to improve the overall solution.

The potential which APIs offer the (re)insurance market is considerable. They provide a means of creatively overcoming the rigidity of many of the systems and workflows upon which the industry currently relies, resulting in significant efficiency enhancements and material increases to return on capital.

> “What APIs facilitate is the ability for all parties in the chain, whether that be a broker, an underwriter, an actuary, to interact with the data in its original state”

JASON FUTERS is CEO of Insurdata



CAUTION IN THE CLOUD

Symphony's **Chad Roth** and **Scott DiPisa** on improving efficiencies while reducing risk for the insurance sector

Did you know that a recent survey of business-to-business (B2B) companies revealed that nearly 80 percent of employees have admitted they use unauthorised cloud-based applications in the work environment?

There should be "caution in the cloud". Think it's unlikely your cloud-based data won't be hacked? Think again. Traditional cloud apps decrypt data in the cloud for processing and analysis, leading to a massively vulnerable pool of data.

At the same time, insurance firms want to be more competitive. In a survey sponsored by MicroStrategy, 85 percent of enterprise decision-makers feel they have a timeframe of just two years to make major inroads on their digital transformation before suffering financially and/or falling behind their competitors.

So, is there an approach that both improves efficiency while also reducing risk and adhering to compliance needs? There is. It's called secure team collaboration. This approach can help insurance companies alleviate competitive pressures by helping them transform customer experiences and leverage customer intelligence in real time.

Introducing Symphony

Symphony is the most secure cloud-based collaboration and communications platform that powers work for many financial sector firms, including insurance firms.

Symphony provides:

- Fully integrated messaging, document sharing, conferencing, and apps for improved workflow efficiency.
- A trusted community of users that can collaborate securely within and across companies, while meeting global compliance requirements.
- Apps and integrations that enrich and extend the user experience.

Below are two use cases that show the possibilities for delivering better business outcomes.

Improve claims experience

Insurance companies can use Symphony to improve customer experience and reduce claims process friction as in the following scenario:

- Newly hired field adjusters can use Symphony on their smartphone to start a chat with an expert in headquarters to get their questions answered during interactions with clients in the field leading to a faster claims process.
- They can photograph damages and securely send mobile attachments.
- Experts provide real-time feedback to the field adjusters to adjudicate the claims.
- Symphony preserves the interaction between the field adjuster and the expert in a persistent chat room for follow up, claims adjudication and compliance audits.

Symphony enables field adjusters at every level of experience to offer seamless customer service experiences and reduce the claims cost.

SCOTT DIPISA is market development lead for insurance at Symphony

CHAD ROTH is an insurance workflow specialist at Symphony

Leverage intelligence

Insurance companies interact with scores of brokers and end customers. Consider this scenario:

- The insurance company deploys Symphony for its customer service, underwriting and product management teams.
- Symphony can integrate with customer service applications like ServiceNow.
- When interacting with clients and brokers, the customer service representative or underwriter receives positive or constructive feedback on the products and pricing.
- The customer service representative or underwriter captures the customer feedback and tags it with #ClientInput or #BrokerInput on Symphony.
- They use "Signals" to triggers a real-time notification to the relevant product managers.
- The product managers compile the feedback from hundreds of representatives to inform the creation of future products and pricing.

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SIGNED, SEALED, DELIVERED

In the first of a second series of articles focusing on M&A, **James Mee** and **Chris Brierley** reflect on some of the trends they have seen in recent M&A transactions

We recently hosted an M&A roundtable for *The Insurance Insider*'s London 100 group, and one of the themes was the frequency with which one encounters 'financial buyers', such as private equity and pension funds.

Looking at our own data, an increasing proportion of our mandates have involved funds, directly or through their investments.

As has been well trailed, brokers and MGAs are easier acquisition targets than carriers, but we are aware of a surprising number of discussions involving carriers – though the conversion rate is much lower.

So far as brokers and MGAs are concerned, what strikes us as a relatively recent development is the number of investors looking to back really quite small or early-stage ventures.

That does not mean that it is easy to obtain early-stage investment – funds are cautious and tend to want to commit relatively small amounts of money to back what they consider to be realistic plans, rather than the (often) more ambitious plans put forward by market entrepreneurs.

Of course, we have seen significant sums committed where the investment case is seen as particularly strong.

Processes

While there are always exceptions, deals seem to be taking longer. Sellers of good-quality businesses look to run auctions and are not afraid of holding out for a good deal – whether in terms of price or, once the headline commercial terms have been agreed, for a good legal deal.

> "Questions often arise as to whether it is a buyer's or a seller's market. Our own recent perspective is that sellers are achieving better legal terms than we tended to see three or so years ago"

Pre-acquisition due diligence processes, however focused and well run, continue to take up a great deal of advisor and management time.

As in other fields, the use of technology leads to more data. With online data rooms, it is much easier to access a wealth of information and ask further detailed questions.

The trick on the buy-side is to work hard to ensure that all diligence workstreams are properly joined up – at the outset, during the exercise, and in terms of reporting. Easy to state, but not always done well in practice.

Anecdotally, we've seen the legal terms for good businesses shift towards being more seller-favourable over the past few years.

What's market?

One of the facets of UK private M&A (i.e. M&A that is not governed by the Takeover Code) is that the legal terms of a deal are rarely made public. This frequently leads to debates as to whether terms being proposed are "market standard".

Questions often arise as to whether it is a buyer's or a seller's market. It obviously depends – on the strength of the case to invest in any business that may be on the block, and the number of potential buyers.

> "We continue to see a high level of interest from North American and Far Eastern buyers. A consequence of this is an increased focus on foreign investment or national security reviews"

Our own recent perspective, which is shaped by the deals that cross our desks, is that sellers are achieving better legal terms than we tended to see three or so years ago.

This may be an impact of institutional investors. Despite the use of transaction risk insurance, the continued ability of private equity to hold the line (or not deviate too far from it) – "Private equity doesn't give [business] warranties" – may well drive legal terms towards being seller-friendly.

In terms of documentation, it is increasingly common where private equity funds are involved to have a shorter form sale agreement, with a separate management warranty deed.

We have seen sellers position sale documents without including the waiver of claims against management. Sellers (whether corporates or funds) rely heavily on management through a sale process (just think of any disclosure exercise and the people involved in that).

Our own view is that it is usually not reasonable to expect management to proceed through the process with the risk of a claim by a seller hanging over them.

It can be different if management are to receive significant value. However, even then, it is tricky to explain to a management team why they should take risk vis-à-vis the seller.

Keeping with the theme of management risk and liability, we rarely see management teams who are going to be exposed to a buyer not arrange indicative terms for a buyside warranty and indemnity policy as part of the deal terms offered to buyers.

This usually leads to a discussion on whether the institutional investors will contribute to the cost of that policy and, indeed, to the deductible in the event of a claim (whether for a covered or uncovered item), in order to facilitate a deal.

Locking and unlocking the box

While by no means ubiquitous, we tend to see locked box mechanisms being used, rather than completion accounts.

A locked box provides greater price certainty, given the purchase price is fixed based on an agreed set of accounts.

The financial discussions that feed into price take place early on in the deal, to agree the price, which tends to reduce protracted post-completion discussions on adjustments to the purchase price.

A key item is the "ticker", to compensate sellers for long periods between the locked box date and completion. If a business is performing particularly well, or badly, attempted renegotiations can be expected.

The concepts of "leakage" and "permitted leakage" are always discussed. We are seeing, as deals take a long time to finalise, management retention arrangements (put in place sometime previously) expire or need refreshing, and the discussion then is how the buyer and the seller bear the increased cost.

The types of buyer

We continue to see a high level of interest from North American and Far Eastern buyers.

A consequence of this is an increased focus on foreign investment or national security reviews. These reviews are becoming more common as conditions to closing, in addition to other regulatory approvals.

The UK has had a limited national security regime in place for a number of years – fewer than ten transactions have been reviewed since the implementation of the current regime in 2003. Most of these have been in the defence sector.

The UK Government implemented changes earlier this year to the thresholds at which the Competition and Markets Authority can review transactions, but these changes were targeted at other sectors such as defence.

However, the Government is now consulting on further changes to the national security regime, which will dramatically increase the number of transactions subject to scrutiny – the Government's current expectation is that there will be around 200 voluntary national security notifications annually, with a full assessment for around half of these.

The consultation remains open until mid-October, and we await the outcome – and the Government's next steps – with interest.

We remain hopeful that the financial services and insurance sectors – both of which already scrutinise proposed buyers for suitability – will not be too greatly affected by the proposals.

We are also seeing transactions being subject to the review of The Committee on Foreign Investment in the United States (CFIUS). This committee is able to review transactions involving foreign investment in the United States, even where the target is not a US company.

So, for example, the acquisition of a UK-based insurer by a Chinese buyer would fall within CFIUS's jurisdiction if the target group has a US subsidiary.

In the last three years for which reports are available, UK buyers filed the third most notices to CFIUS (behind Chinese and Canadian buyers) – so it is worth considering the need for a CFIUS review where there is a US element to a transaction.

JAMES MEE is head of corporate insurance and financial services at RPC

CHRIS BRIERLEY is legal director in the corporate group at RPC

Summer 2018

THE INSURANCE Insider

BERMUDA ROUNDTABLE 2018

Diversification play

How can Bermuda meet the challenge of a changing reinsurance market?

Insight and Intelligence on the London and International (Re)insurance Markets

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LLOYDS BANK

Two microphones and the truth

We don't normally let *The Insurance Insider*'s editor-in-chief Adam McNestrie out of the office.

This is not because we fear that his animal instincts will let us down in any way if allowed out into the wild – indeed, he is impeccably well behaved and utterly reliable.

No, the reason why we keep Adam close to the news desk is because he is so valuable to us there.

He spends every working hour calling his deep and wide contact base across the world and mines a rich seam of exclusive news stories. If the phone rings and he isn't here, we might miss out on the big scoop.

So when a series of diary clashes meant that he had to go to Bermuda to chair one of our regular series of Lloyds Bank Roundtables, this was the first event he had chaired for a long time.

Adam has an unquenchable thirst for the truth. He is also utterly fearless. He always asks the direct question that everyone is thinking about but is too diplomatic to say out loud.

This is what makes what you are about to read so fascinating.

With the market in such flux, there are hundreds of tough questions to ask:

If the old post-cat pricing cycle is dead, what is the Bermudian market for?

Are the days of the independently quoted Bermudian carrier numbered?

Is there anything that the ILS community won't try its hand at?

Does permanent low-return capital's discovery of our market mean that the traditional reinsurance model is broken?

How are we going to tackle our industry expense problem?

How should Bermuda rise to the challenge of InsurTech or handle the new insurance frontiers such as cyber?

We are lucky that it was Adam who was on hand to ask these questions and not someone else. He followed up with laser-sharp secondary and tertiary questions, reporter's tenacity never letting a fragment of truth or insight escape.

Just like a terrier that has a bull by the tail, when Adam is onto something he sinks his teeth into it and refuses to let go.

Suffice to say that the panel was well and truly put through its paces (now back in London, Adam does admit he "goaded" them a little).

I thank them for coming though this trial and the frank and full exchange that ensues on these pages.

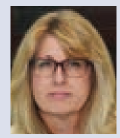
I'm sorry if they are feeling a little bruised, but I'm sure that you will agree that the sparkling debate that follows proves that the end justifies the means.

Mark Geoghegan
Managing Director
The Insurance Insider

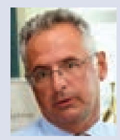
Roundtable participants

Richard Askey
Managing Director – Head of Specialist Insurance, Lloyds Bank

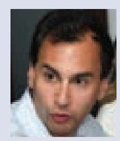
Rob Bredahl
CEO, Third Point Re



Kathleen Faries
Head of Bermuda, TMR



Steeve Jean
CFO, Somerset Reinsurance Ltd



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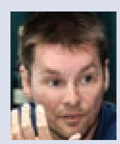

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Anup Seth
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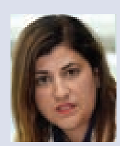

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Bermuda
Roundtable Summer 2018

Adam McNestrie
As a starting point, let's talk about 1/6 and the cat reinsurance renewals. I'm interested in hearing people's feelings about how conditions have been.

Guy Swayne
June renewals started very early, in February – so it feels like it's been a much longer renewal season than in previous years. The counterparties that came to market earlier may have ended up paying a bit more than those that came towards the end and that was deliberate on their part. They were less worried about saving cents and more interested in execution. However, there was clearly an abundance of capacity and capital seeking risk, and that drove pricing down towards the end of May. At some point, prices are going to hit a floor and people will walk away but we sensed that the longer the renewal season went on, risk takers were trying to make up for gaps in business plans or, said another way, searching for premium, and it seemed from brokers' feedback that capacity offered from reinsurers kept increasing to counter the signing-down game.

Adam McNestrie
Kathleen, what was your experience at 1/6?

"Consolidation may be one of the by-products of [M&A], but what we're seeing is people expand their business models"

Sebastian Kafetz

Kathleen Faries
Very much the same. But because of how much third-party capital we interact with, we didn't overestimate a rate increase, although we would have liked it to happen. It came out pretty much how we thought it might, given the capacity. The question, though, is more around sustainability. We keep saying there's a floor but we don't seem to hit it. So what kind of return for everybody is going to be sustainable? I'm still of the mind that we probably need more rate to have a sustainable market or we need to take more cost out of the value chain.

Michelle Seymour Smith
We had much the same experience as Kathleen. Based on what we didn't see at 1/1, we had more realistic expectations of 1/6. So it went as expected, which was disappointing. And like Kathleen said, there comes a point where you question how sustainable it is, especially when complexity of terms is increasing and coverage is broadening to include areas like cyber.

Anup Seth
I'd agree. We work with two very large ILS funds and generally cedants have been pulling all the strings to the extent that they're accessing the capital markets themselves through sidecars, so they have an alternative option. Ultimately, they can retain that risk rather than buy the additional protection if the price is not right for them. So we've seen a couple of placements where they've gone right to the wire and ultimately the cedant has held back and those deals were not done at a particular price.

Adam McNestrie
Well, so much for 1/6! That sets up the broader discussion, which is 'where do you go with that?' An obvious lever that people can pull in a challenged market is M&A and we've seen three examples already in Bermuda. Seb, do you expect to see a continuation in this consolidation trend?

Sebastian Kafetz
I would use the term diversification rather than consolidation. Consolidation may be one of the by-products of that, but what we're seeing is people expand their business models. For example, using life reinsurers as a strategy – there's a stream of new companies setting up on the island. But at the same time, P&C is getting involved in the space in a way that it hasn't done in the past. RenaissanceRe is a good example, setting up a joint venture with RGA called Langhorne Re, and others. If you are diversifying, buying that diversity is often an easier way to do it at scale rather than building it from scratch. In this market companies – especially public companies – won't have the luxury of time to build from scratch. Hence the reason you're seeing acquisitions.

Anup Seth
The M&A activity that we're continuing to see is in the traditional P&C space and it's really driven by fundamentals. It's very difficult to find profitable business and grow organically in such a soft market, and hence companies are looking at growing through acquisitions. On the flipside, with the continued low interest rate environment, we are continuing to see these asset-intensive companies set up on the life side because they continue to see an opportunity in providing a solution to traditional life companies where they provide risk transfer for both biometric and spread risk. As long as interest rates are relatively low, we'll continue to see that opportunity from the US and further afield.

Adam McNestrie
Steeve, is it your expectation that more people, especially on the non-life side, will reach across into the life space?

Steeve Jean
Yes, it's already happening. It's a growing market. The P&C is much more mature, so there's little to no growth and the life side is growing in Bermuda. So that's how we look at it – as an opportunity to grow the business.

Adam McNestrie
Are there going to be cultural barriers or a lack of domain knowledge that's going to make it difficult to jump the fence? Or are they both just types of risk?

Steeve Jean
No, they're quite different obviously. You probably need to go and get talent to be able to build it or acquire it.

Michelle Seymour Smith
Arch has expanded into the mortgage segment, and we see a lot of value in the diversified platform. By operating in non-correlated cycles, we've been able to get a higher average return and lower earnings volatility than our peers. So there's value beyond just new growth opportunities; you can actually outperform by entering into those spaces. The key is to do it well, and in order to do that, you really have to build your own internal expertise. We built up our mortgage expertise internally before we went down the path of purchasing first PMI and then UG.

Adam McNestrie
The counter-argument to diversification is that companies that try and do everything, do everything badly. Is it better to do one thing well than to try and do many things?

Rob Bredahl
If you look at the history of insurance and reinsurance, during periods of stress monoline carriers – whether pure play reinsurers, workers' comp monolines, or single-state medmal mutuals – will all do poorly over time. It's just idiosyncratic to the actual risk – there's market cycles, cat risk and then there's regulators and rating agencies, so some diversification makes sense. Having said all that, are P&C companies diversifying into unknown areas just because it's not the current poor market in which they operate and they can feel better about their assumptions?

"The M&A activity that we're continuing to see is in the traditional P&C space and it's really driven by fundamentals"

Anup Seth

Guy Swayne
Nephila is monoline in terms of property, not necessarily in form and we enjoy having a syndicate in Lloyd's. That market still views cat as one of the more profitable lines of business.

Rob Bredahl
Which is another example. How many standalone Lloyd's entities were there 10 years ago? And how many are there today?

Sebastian Kafetz
And yet valuations for Lloyd's syndicates are still extremely high compared to comps because it gives you diversity by buying into that market. By the very nature of writing lots of different risks in each syndicate, that's a diversified play in itself. So valuations stay high because of scarcity value.

Rob Bredahl
Except 10 years ago everybody wanted a Lloyd's platform, even regional US insurance companies like Hanover. The average price over that period was probably 1.6x or 1.7x, and now 10 years later some of these companies like Hanover are selling the Lloyd's platform, and there was a big drop in valuation.

Scott Maries
One reason for the high multiples is how you capitalise those Lloyd's syndicates. So,if you've got 50 percent of LOCs [letters of credit] up, then you're kidding yourself – it's not the same multiple. Lloyd's is going down this path now where 50 percent of FAL [funds at Lloyd's] needs to be in the form of LOCs but in the past you've had some syndicates where as much as 100 percent of FAL is in LOCs. So when you look at price to book value, you don't really have much book value in your GAAP [generally accepted accounting principles] financial statements because you've got off-balance sheet capital in the form of an LOC. And Lloyd's is smartly retrenching from that.

"The ILS players are all looking at the next thing to keep their profit margin where they need it to be for their investors"

Kathleen Faries

Richard Askey
I agree – that's partly what has helped to drive some of these valuations. Equally, it's some of the money that has come in from Japan to drive those high valuations, because not only is their cost of capital in terms of the acquisition relatively inexpensive, but equally their all-in costs for LOCs are also very competitive, so you kind of win on both points. But I'm still not sure that drives valuations up to 2.4x on occasion. The very long-term investment strategy does help, however.

Sebastian Kafetz
For most of the big global players that use LOCs into Lloyd's, LOCs under Moody's are part of the adjusted leverage ratio debt metric. And therefore if they look at it in the overall debt quantum and say "How much leverage do I want to hold?" an LOC might be substituted for some other form of debt. But ultimately it's about where you are putting debt within your overall company. Often with these big players, you may see an LOC providing capital to their Lloyd's syndicate but that will also be substituting for some other form of debt, under the Moody's capital model.

Adam McNestrie
One final thing on diversification – to what degree do people think that when you've got a shrinking margin on your underwriting, it's just a leverage play?

Guy Swayne
As Michelle said, we're all running businesses with different pressures and similar to Arch, we diversified into the insurance space. However, before you diversify you have to study what fits with your strategy, you have to get the right talent, you have to think it through and then you have to execute your plan. Our industry has been littered with companies that diversified and perhaps didn't execute it very well and they're the ones that have probably come up short.

Anup Seth
Some of the larger ILS funds are looking at leverage now. They're saying our funds have grown to billions of dollars now and historically we were collateralising every dollar of limit with a dollar of hard cash in a trust account. What can we do differently now and in particular to gain some leverage? Credit Suisse set up two rated reinsurers in Guernsey, Humboldt Re and Kelvin Re, and that was one of the key drivers.

Kathleen Faries
That whole evolution is interesting, because initially ILS wanted an alpha play. They didn't want to have an equity position in a rated entity. Now it's evolving and it does have a lot to do with the rate pressures, particularly in property cat. It's the same thing with diversification – it's great but if there's no profit, then that's not a long-term play. The ILS players are all looking at the next thing to keep their profit margin where they need it to be for their investors. Having the leverage provided by a rated vehicle can improve their profit margin, so they have to look at it.

Richard Askey
Do you sense that they've bought themselves more credibility after how they positively reacted to the storms of last year as well? I remember being sat round a table not dissimilar to this in Q4 2017 and the big topic at the time was will they still be here, will they pay up, will they reload, etc. And if anything, that's been proven in spades, hasn't it. This is not alternative capital any more, it seems much more mainstream.

Adam McNestrie
The only question that clouds the issue is Markel Catco and the massive deterioration in their loss number. It's a huge outlier in the market, coming after a massive fund raise. You'll probably see redemptions and lawsuits there. We don't know how that will develop but it will be a codicil to the ILS market's response.

Guy Swayne
Markel Catco aren't here and they should be allowed to speak for themselves. However, when that happened back in March, I am sure it raised awareness in some areas of the investor community of "If it can happen to them, who else can it happen to?" It probably raised some concern about what that means for the ILS space, or the industry in general – sidecars and the like, not just independent funds. It's really a question of transparency and how you communicate with your capital base.

Adam McNestrie
I want to come on to M&A, specifically thinking about the AIG/Validus and Axa/XL transactions. When they happened, the thesis that a lot of people had was that you're going to see big mainstream or composite insurers going out to buy specialty companies. Does anybody think that is a valid thesis?

Guy Swayne
A big driver of a lot of decisions would appear to be expense. Our industry is still incredibly inefficient compared to other financial sectors and there remains a significant level of distribution costs, added to which the industry's use of technology isn't great. With Axa buying XL, there would appear to be synergies, but you would assume that the

management will look to strip out cost based on the price of the deal. Current levels of expense and cost of capital highlights a number of the challenges we have as an industry – whether it's cat or other lines of business, companies should be able to operate in the current market conditions as this may be the rating environment for the next five years.

Anup Seth
To your diversification point, there's also a strategic element to this. If you look at Ace buying Chubb, they accelerated their US mid-market strategy with that acquisition. With AIG buying Validus, Brian [Duperreault] has made it very clear that he's buying a reinsurance brand, he's buying Alphacat and he's buying a Lloyd's syndicate, because they don't have those three things at AIG.

Sebastian Kafetz
A lot of it is cycles. A lot of those composites were in Lloyd's, they have dabbled in the business and have come out. Some of the big composites like Aviva and Axa have played in Lloyd's before, and then have come out and back in again in different ways. So it's not particularly new.

Scott Maries
Just because RenRe and Axis are still standing, it doesn't mean they won't topple. You typically don't get four big companies in the reinsurance market changing hands in 12 months – I don't know a time when that's happened. I wouldn't be surprised if RenRe and Axis got acquired in the next 24 months. In the XL and Validus transactions you wanted to be on the sell side – selling shareholders won big. The buyers clearly had their very specific reasons for paying such full valuations.

Adam McNestrie
What I found really interesting is it seemed like suddenly there was this drop-off in interest in M&A transactions – the buyers seemed to disappear. There's a reason so many properties are being brought to market because fundamentals in the industry are bad.

Scott Maries
Valuations might put people off too. Two big multiple to books – if you think you have to walk into something and pay that to get the asset, more measured buyers may be deterred.

Richard Askey
You've got a contrast as well between the buyers. I don't think you're going to see a private equity business come in at 1.6x or 1.7x because they can't achieve the returns that they need over their chosen investment horizon.

Rob Bredahl
But expected RoEs are, what, 7 percent? And then you pay 1.5x premium and it doesn't work, does it?

Anup Seth
That's why a lot of private equity money is going into the life space because when you look into the average RoEs that you can achieve in the life space, they're low double digit. So in a low interest rate environment, that's really attractive and that's where the push is now for that space and that type of risk.

Adam McNestrie
The quoted sector in Bermuda has shrunk and I'm interested to know whether people think that's for the long term. Is there a future for New York-listed Bermuda companies?

Sebastian Kafetz
There is, for example, the mid-cap-type companies may be too small to move the dial for a big composite and so they may remain independent. The BMA is a relatively easy regulator to work with and you can list a company in the US market at, say, $1bn market cap and list 25 percent of that and find the equity invested in the US market. So some of these smaller niche companies of today could well be the next RenRe or Axis of tomorrow. You'll continue to see listed players, but probably at the smaller end, with the larger end being taken out.

Richard Askey
And you continue to have the support from the rating agencies as well at that small end. You may also consider a start-up company, alternatively.

Guy Swayne
It's likely harder for an A-minus-rated company to succeed now than it was 10-15 years ago.

Scott Maries
Yes, private equity is far less interested in this space. There are rumours that they were involved in the Aspen deal but I don't know how any private equity investor makes a decent return buying Aspen at 1.2x book because you have to get out at 1.5x to make the math work. With $500mn of capital, if you're listing in New York, you are tiny and irrelevant. Public market investors just aren't interested in you.

Sebastian Kafetz
And out of the other side of this is the ability to access the debt market, which is huge as a source of financing for M&A.

"I don't think you're going to see a private equity business come in at 1.6x or 1.7x [book] because they can't achieve the returns that they need over their chosen investment horizon"

Richard Askey

David Keller
We're in a more volatile overall environment and it would be less than honest to say that hasn't affected the debt markets. For the most part, my comments relate primarily to the US debt markets but they also would be true of the euro and sterling debt markets. The markets have been remarkably resilient to the volatility and the macro-political shocks that seem to be occurring every day. There's a tremendous amount of liquidity out there and a tremendous amount of investor appetite across the piece. Certainly, any M&A-driven financings in the sector have been extremely well received. The fact that there hasn't been a lot of activity is driven by a lack of supply, not a lack of investor or market demand.

Adam McNestrie
The challenge as a rated balance sheet business trying to do M&A is you've only got to have a certain amount of headroom for your debt before you start to get rating agency headaches.

David Keller
Right. The formula for the most part seems to be you've got a certain quantum which is the total consideration and obviously you want to start with the cheapest to deliver, but subject to rating agency and leverage constraints. So a lot of these transactions have components that are equity, components that are between debt and equity in that broad family of hybrid securities, but the cheapest to deliver remains straight senior debt. So the idea is to backfill with as much of that as you can, within the tolerance of leverage.

Adam McNestrie
Let's move on to the use of third-party capital and the fees that it generates. To what extent can balance sheet businesses become hybrid balance sheet and asset management businesses and make that a successful twin model? Is that a big part of the future of Bermuda?

Scott Maries
It's something of a necessary evil given the ease with which pension fund capital can access the cat market directly. What I've seen is the internal struggle between whether a company builds out its ILS fund or whether it writes for its own account. If a cat reinsurer is targeting a certain dollar value of net income per annum, it is far easier to hit that target by writing for its own account, as the margins on fee business can be razor-thin, particularly if the ILS fund has less than $2bn of assets under management.

Anup Seth
Because of the margin compression, one of the big things that you cede away is that ceded premium and that risk exposure. So now you've got another way to generate some fees by doing that, rather than just a profit commission on your ceding premium. You can set up a sidecar or an ILS third-party fund, and you feed that business into the fund and generate the fees that way.

Michelle Seymour Smith
Arch sees third-party capital and the associated fees as an opportunity, as shown by Flatiron Re and Watford Re. While we like to get a 20 percent RoE on risk-bearing business, we'll quite happily take a value stream that's not risk-bearing and doesn't require us to put capital against it. However, the key is to be flexible and agile enough to pivot in terms of whether it belongs on our balance sheet or someone else's and adapt to where the returns are.

Rob Bredahl
This will follow the same pattern as the commercial banking industry. Banks used to make loans and take deposits and put it on their balance sheets. Then with the advent of the securitisation market, they started generating fees and they were warehouses of risk. Investment banks were more intermediaries and the commercial banks were more balance sheets, so they have been banged together and they are somewhere in the middle.

Anup Seth
The challenge for the ILS funds is not so much on the investor side, it's more on the where to deploy the capital that they have. We've seen a few ILS funds now diversify and set up life funds, for example, so they're deploying their assets in a diversified way.

Kathleen Faries
We've been involved with third-party capital since 2003 and the way that we're setting up the strategy is recognising that eventually there is going to be more pressure on the costs, so the technology play for us has been critical. We have to scale in order to make that strategy work, fronting and transacting with lots of different asset managers, and you can't do that without the technology. So we've built our technology assuming that eventually that value chain is going to start shrinking and the potential for trading more efficiently with different capital pools will become more likely.

Adam McNestrie
Does anyone want to comment on the idea that writing cat reinsurance risk on a rated balance sheet is going to be seen as being a total anachronism in three to five years' time?

Kathleen Faries
We may see this shift over time, but regulation will certainly play a key role.

Adam McNestrie
But don't you just front it and have the tail risk taken by the rated players?

Kathleen Faries
That's one way to do it, but again, the cost is the critical thing there, because everybody has to deal with the cost of doing business that way. So, we either have to reduce the cost of transacting business, or investors are going to build their own rated balance sheets to focus on reducing costs.

Adam McNestrie
If we're talking about acquisition and expense costs, what has the reinsurance sector got to do to be sustainable?

Anup Seth
It's got to get to sub-20 and then that loss ratio can go up to 70 percent. If you look at the combined ratio split, at

the moment we're more like 50-60 percent loss and 30-40 percent expense and acquisition costs. I think we need to go to 70/20 so our offering has more value to the cedants – so they can actually see more value and there's more payback on the loss side. But our total expenses need to be sub-20.

Rob Bredahl
The acquisition and G&A expense ratios are very different depending on what model you're talking about. If you take a primarily excess writer such as Fidelis or Validus, they have very high G&A expense ratios because their expense relative to the premiums is higher. Our G&A expense ratio is about the lowest in the industry because we write all pro rata business, but we pay up for acquisition costs because of the quota shares. Having said all that, something has to give. If you follow the trail from the owner of the risk to the ultimate risk taker, all the costs that come out of it are insane.

Kathleen Faries
And there's a massive amount of duplication of effort.

Richard Askey
But with that efficiency we haven't really seen any dramatic improvement over a 10- to 20-year period, whether you're in a hard or a soft cycle. Is it that difficult to chase costs down?

Kathleen Faries
There's a lot of vested interest in keeping it all there. That's why outside disruption has real potential.

Adam McNestrie
Isn't it also about the extent of the value chain? There's so many people touching the business. Maybe that needs to be fundamentally restructured, if you're going to take a significant amount of cost out of the industry.

Kathleen Faries
Technology is going to facilitate some of that. If you have the right technology in place, you'll start to see capital accessing the risk more directly. It might be parametric, maybe there will be a blockchain solution, but the idea is that the transaction will be simplified so that capital will be able to access the risk and basically collapse the value chain.

Adam McNestrie
Who controls that process? The brokers?

Kathleen Faries
The brokers will be there. We're still going to need people to help us understand the risk – that could be the broker, it could be others, but the brokers are always going to play a role. It's just the way that the transaction is accomplished that is going to evolve over time.

Rob Bredahl
There's plenty of business plans where the distribution strategy is to bypass brokers and agents and go straight to the clients, but most of those have been unsuccessful. The product is so heavily regulated and so complicated, the buyers just want a trusted expert to help them. So the direct distribution models are tough except for in a couple of areas.

"There's plenty of business plans where the distribution strategy is to bypass brokers and agents and go straight to the clients, but most of those have been unsuccessful"

Rob Bredahl

Anup Seth
However, if you look at the broking model, that traditional concept earning your commission just through pure placement is a thing of the past. If you look at our vision now, it's to be the leading professional services firm, with a focus on risk, retirement and health. So we're changing tremendously to focus on that broader value chain and value proposition around risk – and risk transfer is just one element of it.

Adam McNestrie
It's very hard to achieve significant reduction in costs without significant reductions in headcount. Is there a bit of a collective failure in addressing that at the moment?

Guy Swayne
It goes hand in hand with technology. If you bring technology to the forefront and become efficient, you need less bodies or as a business you can redirect those bodies in other areas. If you take a cat programme, for example, it may have three brokers involved. They model it and then send it to 50 reinsurers and we all model it similar ways. If that gets stripped out, the savings in just placing one programme must be significant. The broker continues to have a strong control over the business. Using Aon as an example, they've invested a lot of money over the years in headcount and technology and many reinsurers can't compete with that level of investment.

Scott Maries
In the legacy space, the types of deals drive the expense ratios. If you look at the other run-off players, their G&A as a percentage of investment portfolio, ranges between 2 percent and 4.5 percent. So if they can make 4 percent, they're covering their G&A.

Sebastian Kafetz
And then you have an outsourced model like Watford Re that has a thin staff but is obviously utilising the expertise

of investment from one place and then underwriting from another place. So that model is quite a people-light one, I assume.

Michelle Seymour Smith
Yes, and from Arch's perspective, Watford Re has worked well. But it goes back to what Kathleen was saying earlier about needing to have the scale and the flexibility. From Arch's perspective, to the extent that we're managing the underwriting and the administration of the business, it's been an add-on to what we already do. We didn't take on additional headcount to do that, so for us it was an opportunity to earn more fees, leveraging the resources we already had.

Kathleen Faries
The end-game, really, for everybody should be not so much that we want people to be out of jobs, but you want to free people up to solve bigger problems and find new ways to address the protection gap. And that's what technological advances have shown in other instances. Even with automation, with robotics, you still need people; they're just doing different things.

Adam McNestrie
Before we finish, I would like to come on to the total return reinsurer model. What role does that have within the broader Bermuda ecosystem going forward?

Rob Bredahl
The idea is that, because of what goes on with the investment side, the investment returns are our economic engine. We've teamed up with a hedge fund that can generate outsize returns, but it comes with volatility. We mark everything to market; traditional companies have fixed-income portfolios that aren't generally marked to market. We always knew we'd have more volatility; the hope was we'd make up for it by having higher returns. Most of the investment strategies that are embedded within hedge fund reinsurers have underperformed on average, with more volatility. And that's where the model has broken down. Now, having said that, we don't write cat, we have hedge fund-type returns and our results aren't correlated with other reinsurance companies, so last year our RoE result was 20 percent. We ended up as the number-one reinsurance company in terms of RoE. The year before that, it wasn't so good, but it's just different.

Michelle Seymour Smith
The model is not necessarily flawed because there is volatility or under-performance. Even traditional reinsurance companies fail for these reasons.

Rob Bredahl
And the investors have an equity fund and a fixed-income fund because, for long periods of time, where one underperforms, one outperforms. One is not better or worse; they're just different.

Anup Seth
But going back to the classroom, we were always taught that traditional reinsurance companies take the volatility on the liability side of the balance sheet, and the asset side is there to have a matching strategy to preserve capital and maintain liquidity, so you can pay claims as and when they fall due. That manual is out of the window now when you're looking at some of these new models.

Scott Maries
But I'd argue that manual isn't terribly applicable to some more traditional reinsurers. The last time I did the math – when I was wearing a banker's hat, and Third Point was going public – we were trying to convince investors the business model made sense, and it wasn't too different from some of the traditional reinsurers. I remember looking at a number of traditional reinsurers over a prolonged period of time, and what you saw was approximately 60 percent of their net income coming from investment income, and not from the underwriting side. So, you could argue that volatility is on the underwriting side but significant earnings are coming through from the asset management side.

Rob Bredahl
The other fact is – picking on Arch again – your investment leverage, total assets to surplus is probably 3.5-4.0 to 1? Whereas ours is 1.5 to 1. With the fixed-income portfolio, when there's massive interest rate movements in mark to markets, they don't go through the P&L; they bypass it and go to net equity. So if you look at the net equity volatility and compare it to us, I don't know if it's that different, but the P&Ls are different. We recognise that we have more volatility in our liabilities and so we manage our investment leverage accordingly. If you look at our enterprise risk, it's very similar to traditional companies; we just share it on both the investment and the liability side.

Guy Swayne
There's no right or wrong model, it's how you execute your plan, measured over an acceptable duration and, to some degree, provide transparency. If capital isn't surprised by what happens, then you're fine. If you surprise people, in the wrong way, then you're likely to have a problem.

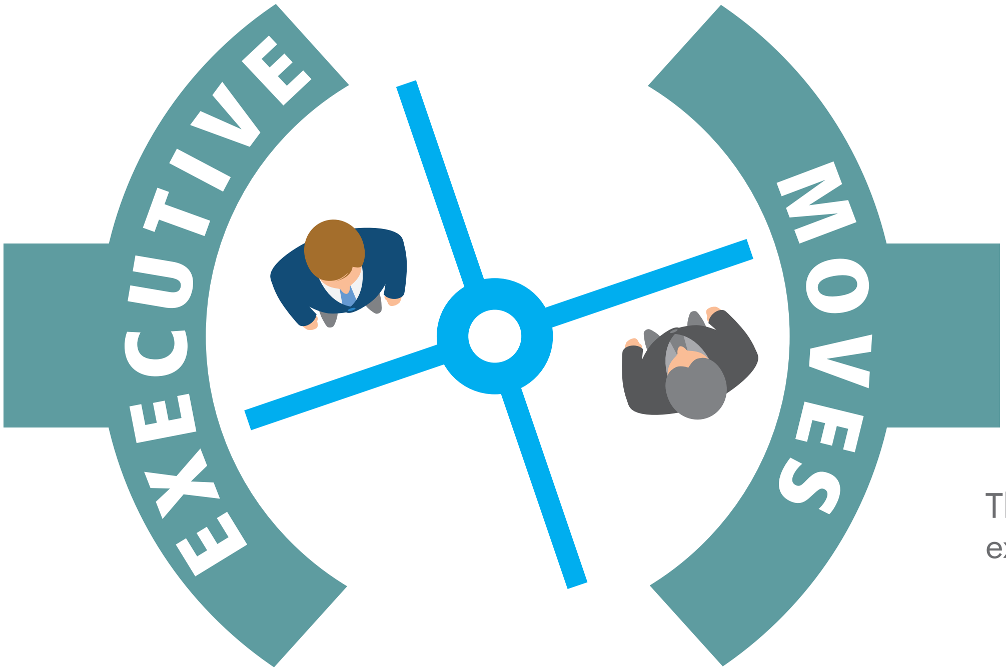
Adam McNestrie
I think Rob made the killer point, which is the 20 percent RoE last year. If you guys put up two more years of 20 percent RoEs, people aren't going to be saying well I don't know about this hedge fund reinsurer model. But you know, the hedge funds have underperformed over the last few years.

Anup Seth
Isn't part of the challenge with the hedge fund re models finding that float at a combined ratio of less than 100 percent in this environment? That's challenging as well.

Sebastian Kafetz
Does a combined ratio need to be less than 100 in that model?

Anup Seth
It doesn't need to be, but it helps.

Adam McNestrie
On that note, we should bring it to a close. Thank you very much for your contributions.



The Ins and Outs of the executive job market

Ulrich Wallin

Hannover Re's long-standing CEO Ulrich Wallin is to retire next year. The reinsurer has named Jean-Jacques Henchoz, current head of EMEA at Swiss Re, to replace him. Wallin has been at Hannover Re for 35 years and has been CEO since 2009.

Henchoz will take the reins at Hannover Re from 8 May.

David McElroy

David McElroy has been named by AIG as CEO of its E&S subsidiary Lexington, following the departure of George Stratts. McElroy, who has been executive chairman of Arch Insurance Group and vice chairman of Arch Worldwide Insurance Group since October 2017, will take over from interim CEO Lex Baugh.

Thomas Lillelund

AIG has named Thomas Lillelund as its new CEO for AIG Europe, reporting to international general insurance CEO Chris Townsend.

Lillelund was formerly Aspen Re CEO. Anthony Baldwin, who is currently chief executive of AIG Europe Limited, will become CEO of AIG's new UK entity, American International Group UK.

Emil Issavi

Following Thomas Lillelund's departure, Aspen has named its reinsurance chief underwriting officer Emil Issavi as the new CEO of Aspen Re. Issavi was previously president and CUO and managing director, Americas, at Aspen Re.

Vijay Mavani

Aon's corporate solutions director Vijay Mavani is to leave the broker for a similar role at rival JLT. Mavani, who has worked for Aon for 17 years, was part of the global portfolio broking team run by Andrew Matson.

Clare Lebecq

The London Market Group has appointed Clare Lebecq as CEO, starting on 1 November. Lebecq is currently operations director at JLT Specialty, having been at the broker for seven years. She previously held operations roles at Sagicor at Lloyd's, Cooper Gay and Guy Carpenter.

Susan Rivera

Tokio Marine HCC has promoted COO Susan Rivera to succeed Christopher Williams as CEO, with effect from 1 September, with Williams becoming managing executive officer and co-head of international business for the overall Tokio Marine group. Before joining Tokio Marine in April, Rivera spent nearly a decade at the helm of MGA V3 Insurance Partners.

Colin Grint

Charles Taylor Managing Agency has appointed Colin Grint as CEO, subject to regulatory approval. He is expected to take up his role later in 2018. Grint is currently chief executive of Capita Managing Agency, manager of Probitas syndicate 1492 and former manager of Allied World Syndicate 2232.

Darren Doherty

Dual has hired former Pioneer CEO Darren Doherty to its senior management team as part of a wider shake-up. Doherty, who founded Pioneer in 2011, left the firm in February and is expected to join Dual in the third quarter, possibly in a business development-type role, sources said.

Tom Booth

Legacy firm Darag has appointed Tom Booth as group CEO. He joins from Randall & Quilter Investment Holdings in Bermuda, where he was group CFO. Former Darag CEO Stuart Davies will remain as executive chairman until the transition is complete, becoming non-executive chairman after.